FIRSTwestern TRUST

2Q14 Economic & Market Review

Points of Interest

- 1Q14 GDP the lowest since 1Q09
- 2Q U.S. economic data rebounded following severe winter weather
- Low volatility permeated the equity markets
- Bond markets benefitted from further backup in interest rates
- The ECB announced additional measures to stimulate the economy and prevent deflation
- China economic data stabilized from weaker first quarter
- Emerging markets rebounded following weak first quarter

Inside this Issue:

Overview……………………2
- S&P 500 Chronology
- Economic Scorecard

Domestic Economic Review………………………..3

International Economic Review………………………..4

Equity Markets …………….5

Fixed Income Markets….6

Disclosures…………………..7

Second Quarter Recap

Second quarter was marked by several highlights and trends, but perhaps none were more pronounced than the sustained lack of volatility in equity markets. The second quarter also bore witness to a rebound in U.S. economic data following a dismal first quarter, further tapering by the Fed, new stimulus from the European Central Bank (ECB), improved Chinese economic data and a spike in geopolitical tensions.

First quarter GDP growth fell to –2.9% due in large part to unusually severe weather experienced across much of the country during the winter. Inventory investment, exports and government spending all fell, while consumer spending slowed significantly. Second quarter economic data clearly pointed to a rebound in economic activity, the extent of which remains unknown. Most economists anticipate GDP growth of 2.5-3.0% for the remainder of 2014.

Consistent with their first quarter actions, the Federal Reserve continued to cut its bond buying program during the second quarter. With the Fed announcing that it plans to conclude its tapering in October, investors are now focused on when the Fed will begin to raise short-term interest rates.

In June, the ECB unveiled a series of new measures intended to spur economic growth and head off the threat of deflation. While it remains too early to determine the efficacy of the measures, the ECB has demonstrated its willingness to be proactive in tackling issues facing the region's economy.

China economic data improved during the quarter, providing support to the entire emerging markets complex. Indian elections which resulted in a pro-business candidate winning in a landslide were also positive.

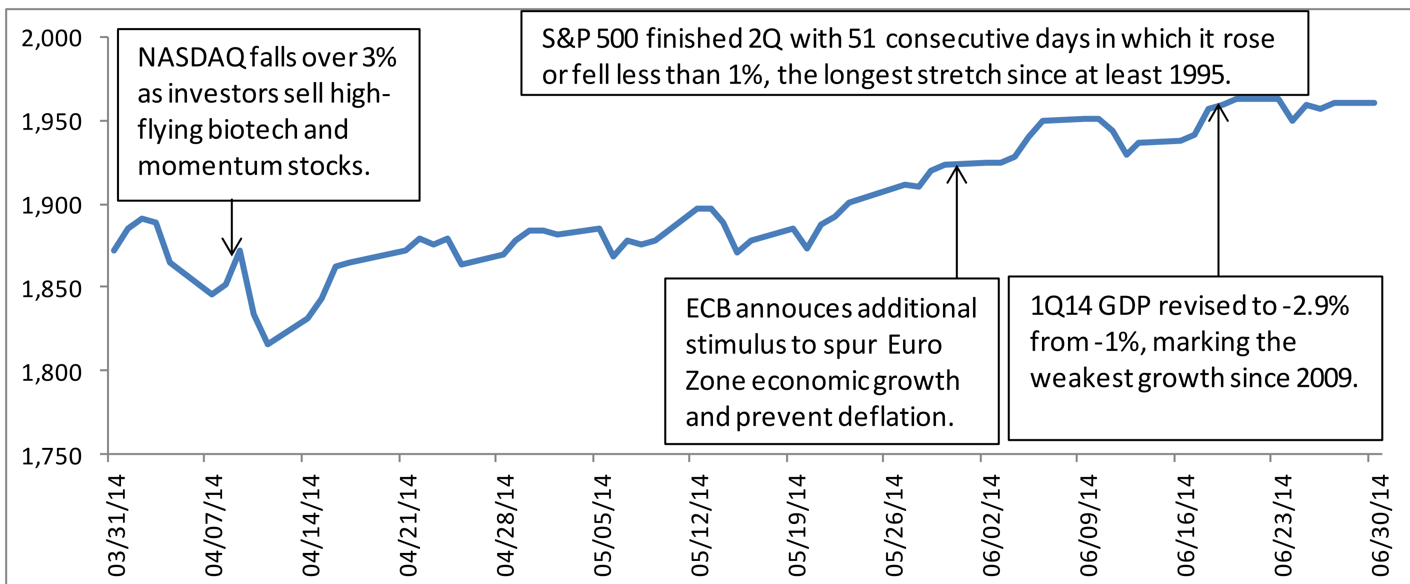
Geopolitical tensions were highlighted by increased fighting in Ukraine between government forces and pro-Russian rebels and the rapid advance of a radical Sunni group across much of northern Iraq.

Second quarter was marked by a lack of volatility in equity markets and a further backup in rates in fixed income markets. While there has been significant discussion in the press about whether equities are currently overvalued, we generally agree with Fed Chair Janet Yellen's assessment that valuations are within historic norms. Looking forward, we continue to believe equity markets are overdue for a 10%+ correction but that timing such an event is nearly impossible. The performance of fixed income through the first half of 2014 has been a good reminder that markets often deviate from even the strongest consensus. Thus we continue to advocate that investors maintain a well-diversified portfolio in order to reach their long-term investment goals.

OVERVIEW

2Q14 S&P 500 Chronology

The S&P 500 moved higher for most of the quarter, following a brief selloff in early April. Volatility was virtually non-existent, raising concerns about investor complacency given the amount of time since the last 10%+ pullback.



Source: First Western Trust

Economic Scorecard

Indicator	Level	Outcome	Trend*	Comment
1Q14 GDP	-2.9%	WTE	↓	Down from 2.6% growth registered in 4Q13. Impacted by declines in inventory investment, exports and government spending as well as a slower pace of consumer spending due to severe weather.
U.S. Unemployment (Jun.)	6.1%	BTE	↓	Best level since Sept. 2008. Economy added an average of 1.385M nonfarm jobs during the first six months of the year marking the best first half of any year since 1999.
Housing Starts (May)	893K	WTE	↓	Y/Y up 7.5%, but down –10.8% from May. Month-to-month, housing starts have been volatile through the first half of 2014.
Case-Shiller Home Price Index (Apr.)	0.2%	WTE	↓	Up 10.8% Y/Y. April marked the 14th consecutive month of double-digit increases, but was also the slowest pace in over a year.
CPI (June)	0.3%	BTE	↑	Headline inflation up 2.1% Y/Y. Core inflation up 1.9% Y/Y.
Consumer Spending (May)	0.2%	WTE	↑	Up 1.9% Y/Y.
Personal Income (May)	0.4%	Inline	↑	Up 3.5% Y/Y.
Consumer Confidence (Jun.)	85.2	BTE	↑	New recovery high and best level since Jan. 2008. Strength broad-based across both present situation and expectations.
ISM Manufacturing (Jun.)	55.3	WTE	↑	Second consecutive monthly increase. New orders strong, as were production and imports. Backlog orders and employment soft.

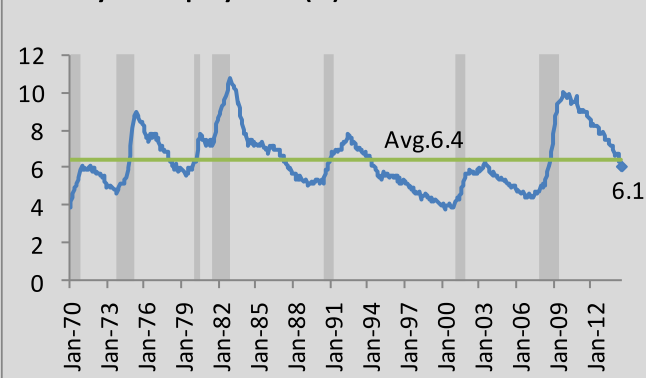
Outcome: BTE= better-than-expected; WTE= worse-than-expected; Inline= as expected. * Trend reflects month-over-month change except GDP which is quarter-over-quarter; ↑indicates improvement from prior month; ↓ indicates deterioration from prior month.

DOMESTIC ECONOMIC REVIEW

U.S. economic data improved in the second quarter, along with the weather, easing concerns about the strength of the U.S. economy that surfaced in the wake of first quarter's –2.9% GDP growth, the weakest since early 2009. Unemployment fell to its lowest level since Sept. 2008, consumer confidence reached its highest level since Jan. 2008, small business confidence reached a new recovery high, housing improved albeit modestly, and the Fed continued to reduce its stimulus. While the post-recession recovery continues to frustrate many economists in terms of its sub-optimal pace, importantly it continues to make positive strides.

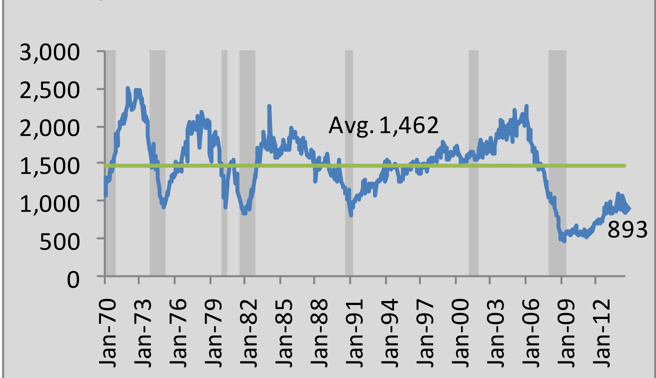
First quarter GDP growth fell to –2.9%, from 2.6% in the 4Q13, marking the worst quarter since 1Q09. The decline was led by a sharp reduction in inventory spending, along with a fall in exports and government spending, and a reduced pace in consumer spending. While there remains some debate as to whether the decline was completely attributable to severe winter weather or a more fundamental economic slowdown, the general consensus is that the economy will grow in the 2.5 –3.0% range for the remainder of the year

Unemployment continued to fall during the quarter, dropping 0.6% from March, to end at 6.1% following the June employment report. Nonfarm payrolls added an average of 272k jobs/month during the quarter, marking the best quarter since 1Q12, when the economy added 276k jobs/month. Additionally, non-farm payrolls added 1.385M jobs in the first half of the year,



marking the best first half of any year since 1999.

While both non-farm payrolls and private payrolls have now recovered all the jobs lost during the recession, the quality of the newly created jobs has been questioned as many have occurred in industries associated with lower wages. Further, many of these newly created jobs have been less than full-time as evidenced by the fact that full-time employment of 118.2M remains about 3% below its Nov. 2007 peak of 121.9M. Nonetheless, the strength of recent employment gains are



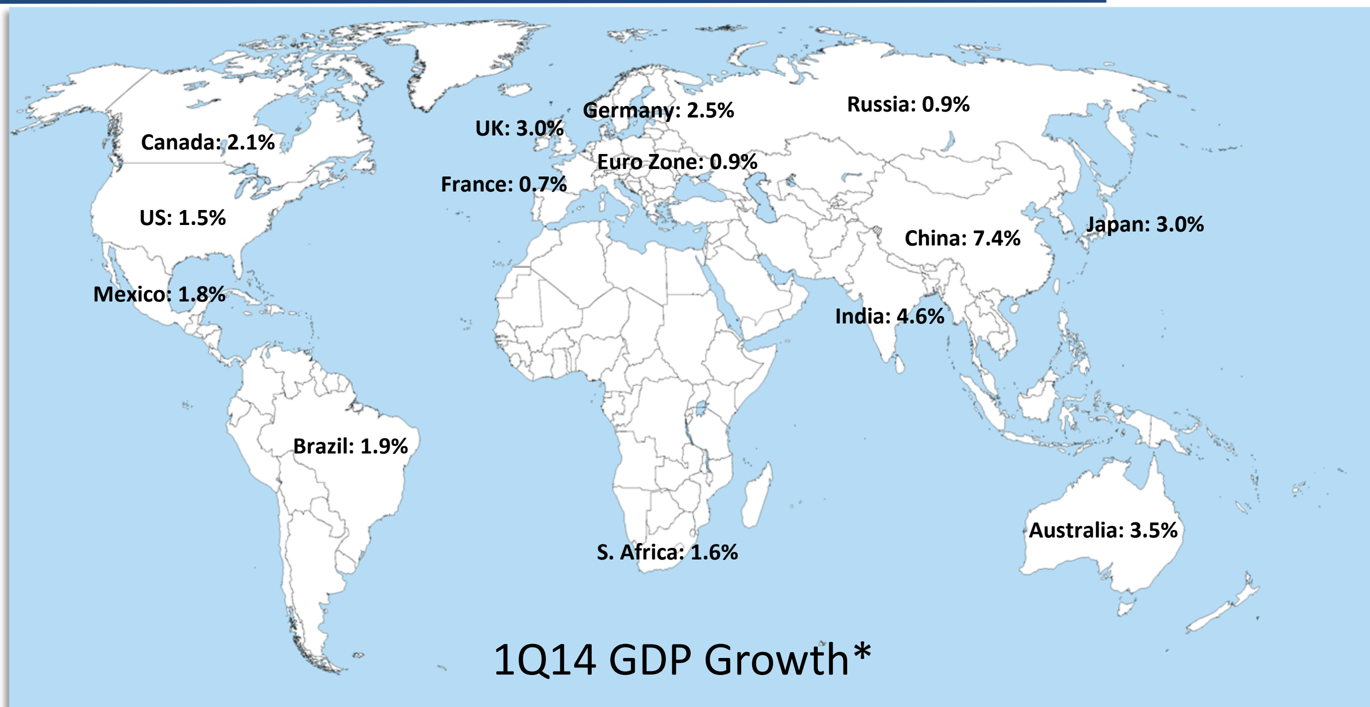
promising, suggesting that employers are feeling increasingly confident about the economic recovery.

Housing activity generally rebounded during the second quarter but was also marked by increased volatility. While it would be premature to suggest that the housing market has plateaued, it does appear to have decelerated of late. The housing market recently has been hampered by a shortage of buildable lots and experienced construction workers, as well as higher prices, and mortgage rates that have climbed from historic 2012 lows. The upside is that prices have continued rising at double-digit rates which has reduced the number of "underwater" mortgages. As homeowners regain equity in their homes, those who have wanted to sell might now do so. This would have the effect of boosting supply which has been constrained over the past year. Additionally, foreclosure filings continue to decline at a rapid pace, a further sign of healing in the housing sector. Though housing has not reaccelerated to the extent many economists had expected, and remains well below its long-term average by many metrics, the overall backdrop remains supportive for further improvement in this important economic sector.

Consumer confidence ended the second quarter at its best level since January 2008. In a further sign of increasing consumer confidence, June auto sales reached an annualized rate of 16.9M, the best month since July 2006.

Small business confidence reached a new recovery high during the quarter which bodes well for the economic recovery moving forward.

INTERNATIONAL ECONOMIC REVIEW



Source: Bloomberg, First Western Trust. *All GDP growth figures shown as year-over-year percent change. U.S. GDP is typically expressed as a quarter over quarter rate that is then annualized.

The second quarter witnessed new easing from the ECB, continued debate about the efficacy of Abenomics, improvement in China's economic data, and a landslide victory in Indian elections.

Euro Zone economic data, which had improved for much of 2013 and first quarter 2014, began to moderate during the second quarter. Specifically, PMI manufacturing and services data for the region and its two largest economies– Germany and France– deteriorated in May and June. While the composite data for the region remained above 50, indicating overall expansion, the deceleration bears watching.

Since 2012 when ECB President Mario Draghi famously stated that he would "do whatever it takes" to defend the Euro, European sovereign debt yields have steadily declined. That downward trajectory continued in the second quarter in the face of weakening economic data as investors anticipated further ECB action.

In June, the ECB announced additional measures to both stimulate the region's economy and address the growing concern of potential deflation. Collectively, the measures were intended to encourage increased bank lending to the private sector. This was highlighted by the ECB lowering its key deposit rate from 0.0% to –0.1%; effectively charging European banks 0.1% to park their excess liquidity with the ECB.

On the heels of the ECB's decision, the yield on the Spanish 10yr bond fell below that of the U.S. 10yr bond. That is not to say investors see the debt of Spain, a country beset with 25% unemployment, as less risky than U.S. debt. Instead, it more accurately reflects investors' expectations for future monetary policy regarding the two countries. In the case of the U.S., investors continue to expect rates to rise as the economy improves and the Fed concludes its tapering. In the case of Spain and other Euro Zone countries, the expectation is that the ECB could eventually enact quantitative easing, which could result in even lower yields.

Japan undertook the next step to revive its economy when it raised the sales tax from 5% to 8% in April. In the immediate aftermath retail sales fell significantly as the tax increase pulled forward a substantial amount of consumer spending into March. May retail sales were essentially flat on a year-over-year basis, and better than expected, suggesting that consumers were again spending following the tax increase. Spending benefitted from a recent uptick in wage growth which is critical for the Bank of Japan to achieve its goal of stimulating the economy. While Abenomics, the economic policies of current PM Shinzo Abe, has shown signs of reviving the country's moribund economy, questions remain about their long-term efficacy which will likely

only be answered with time.

China economic data, which had shown signs of weakness in the first quarter, stabilized during the second quarter. First quarter GDP growth of 7.4% was essentially inline with the official target of 7.5% while more recently, fixed asset investment, retail sales an industrial production have all been inline with expectations. As China continues to transition its economy from one led by large scale infrastructure spending and exports to one led more predominately by consumption, economic data will likely experience periods of volatility. China's leadership has largely proven adept at making subtle adjustments at the margin to ensure that the economy does not stagnate. That was evidenced by June PMI data (a measure of business activity within the manufacturing and services sectors) which rose to a six-month high following a series of small measures taken by the country's leadership to maintain economic growth following some signs of weakness.

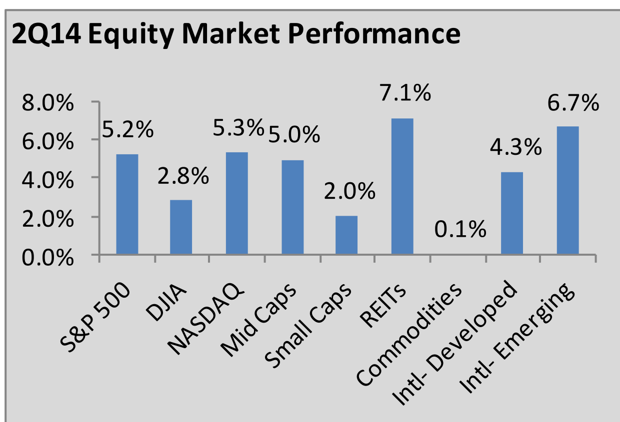
India, the world's largest democracy, held elections in May resulting in the resounding defeat of the Indian National Congress Party which had largely ruled the country since gaining its independence in 1948. The new Prime Minister, Narendra Modi, who ran on a platform of job creation and clean, efficient government, was favored by the business community. Modi's victory helped drive a 20% gain in the Indian stock market between March and June, helping support overall emerging market indices.

Emerging markets rebounded in the second quarter following a selloff in the first quarter. Improved Chinese economic data, a reacceleration in U.S. economic data and actions taken by individual countries to address fiscal issues all contributed to the gains.

From a geopolitical standpoint, second quarter saw ongoing violence in the Middle East and Ukraine. In Iraq, the Sunni militant group Islamic State of Iraq (ISIS) seized large swaths of northern Iraq, threatening an actual assault on Baghdad. In Ukraine, fighting between government forces and pro-Russian rebels intensified following the annexation of Crimea. Though the rebels were dislodged from some of their strongholds, presumed Russian military support has made it difficult for Ukraine forces to secure a final victory.

EQUITY MARKETS

Domestic equity markets moved steadily higher, setting new records, against the backdrop of slow but steady economic improvement and continued moderate corporate earnings growth. Gains were broad-based with all ten major industrial sectors posting positive returns. While growth stocks rebounded during the second



quarter, following selling pressure in the first, value stocks led the way, posting the strongest returns across all market caps. REITs were again the best performing asset class, continuing their strong performance from first quarter, aided by a further backup in interest rates.

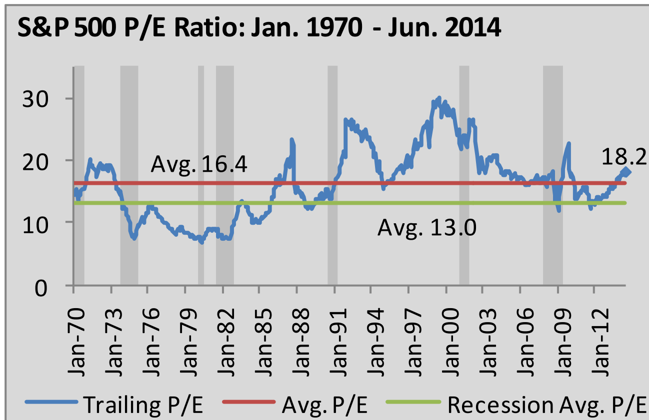
On a relative valuation basis, when comparing large, mid, and small caps against each other, we continue to view large caps as the most attractive asset class. That does not necessarily mean that small and mid caps are set to underperform (these types of relative valuation gaps can persist for extended periods of time) but it is something that should be considered when making asset allocation decisions.

Emerging markets rebounded from a weak first quarter to record solid second quarter gains. Improved Chinese economic data and actions taken by individual countries to address fiscal issues provided support for the entire emerging markets complex as solid gains were recorded across all major emerging market regions. Emerging markets also benefitted from a significant valuation discount to other developed markets, nervousness about U.S. valuations, and questions surrounding the sustainability of the European and Japanese recoveries.

Notable during the quarter was the general lack of volatility. The VIX, an index that measures volatility and is often referred to as the fear gauge, fell to levels not seen since early 2007. Illustrating the low volatility was the final 51 days of the quarter during which the S&P 500 failed to increase or decline by more than 1% from

the prior day's close. That marked the longest such streak since 1995 and led some analysts to fret about investors becoming overly complacent.

On the heels of the U.S. stock market's steady advance, valuations are now trading at, or slightly above, longer-term averages. Some pundits have argued that the S&P 500 is actually overvalued. That has provided fodder for market "bears" who suggest that the market is close to a top and due for a pullback. On average, since 1900, U.S. equity markets have experience a 10%+ correction once a year and a 15%+ correction once every two years. While we certainly agree that U.S. equity markets are overdue for a correction, we do not believe that markets are overvalued. In her recent Congressional testimony, Fed Chair Janet Yellen noted that while prices for a wide range of assets have risen, they "remain generally in line with historic norms". On the whole we would agree.



Looking ahead to the second half of 2014, we continue to expect an increase in volatility. With the Fed scheduled to conclude its tapering in October, we believe that investors will increasingly shift their focus back to company fundamentals. That transition, from a rising tide of easy monetary policy which helped lift "all boats" to one that is driven more by fundamentals could certainly result in heightened volatility.

Geopolitical events are always hard to predict but could also act as a catalyst for increased volatility, or even the trigger for a selloff. Increasing tensions between the U.S. and Russia over fighting in eastern Ukraine likely will not impact domestic equity markets but bear watching, as further economic sanctions against Russia are expected during the third quarter.

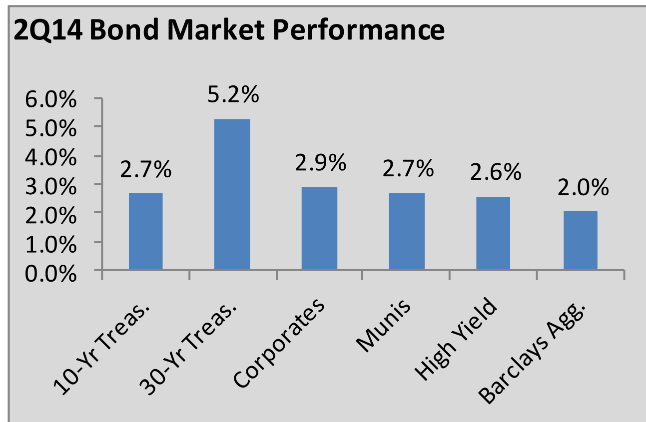
Based upon historical averages alone, we would not be surprised if the markets experienced a 10%+ correction at some point during the second half of 2014. However, we would view such a pullback as part of a properly functioning market and not the end to the secular bull market that has prevailed since early 2009. For investors, trying to time such an event is nearly impossible and long-term investors would be well advised against trying to do so as the opportunity cost is often greater than the actual market decline.

FIXED INCOME MARKETS

Bond markets extended their gains from first quarter as interest rates continued to decline and credit spreads tightened further. During the quarter, the 10yr Treasury yield fell ~0.2%, ending at 2.52%, close to its lowest level in the past 12 months.

The yield curve flattened, with longer-dated rates declining more than shorter-dated ones, driving outsized performance for securities with longer durations. This was evidenced by the strong performance of the 30yr Treasury. The backup in rates observed during the quarter was likely attributable to several factors including lingering concerns about the health of the U.S. economy, investors de-risking portfolios due to concerns over equity valuations and geopolitical tensions, and further declines in Euro Zone yields which increased the relative attractiveness of U.S. debt.

A side-effect of the continued positive performance within fixed income has been increasingly tight credit spreads. While the spread between corporate and high yield bonds vs. Treasuries remain above the lows ex-



perienced just prior to the recession, they are now well below their longer-term averages. Some analysts point to the health of corporate balance sheets and the very low default rates as an appropriate rationale for tight spreads. Others caution that investors are not being adequately compensated for the risk they are assuming at current spread levels.

In the case of high yield bonds, while we are sensitive to tightening spreads, we continue to view the fundamental backdrop for this sector as constructive. Corporate balance sheets remain strong, earnings growth has been respectable and appears to be increasing, and given the fact that many companies have refinanced at very attractive interest rates over the past several years, we would expect default rates to remain near historic lows for at least the next two years.

Puerto Rico returned to the headlines in late June when the territory passed a new law enabling certain public corporations to enter into restructuring talks directly with creditors. The law fundamentally changed the structure of the Puerto Rican muni market and was immediately challenged as unconstitutional, but not before markets reacted with bonds of certain agencies falling below 40 cents on the dollar. Plaintiffs argue that the new law bypasses federal bankruptcy laws. Whether or not they prevail remains to be seen. What is certain, however, is that Puerto Rico's reputation in the bond market has been tarnished and that investors in the future will think long and hard before committing capital, afraid that the government may arbitrarily decide to change the law at some later date.

Looking forward, we continue to believe that interest rates will most likely begin to rise as the Fed concludes its tapering, however, determining when is difficult. As the first half of 2014 has made clear, the consensus view does not always prevail. Investors who reallocated their bond holdings into equities at the start of 2014 not only exposed themselves to higher risk, but also deprived themselves of an important source of income. Just as trying to determine a "top" in the equity markets is nearly impossible, so too is determining exactly when interest rates rise. A long-term investor would be well advised not to attempt either and instead maintain a well diversified portfolio.

DISCLOSURE INFORMATION

- The information provided in this presentation is for illustrative purposes only. Actual individual account results may differ from any performance shown herein.
- All performance is shown gross of fees.
- Past performance is not a guarantee of future results.
- "Risk" as used in this presentation is presented on the historic volatility of returns, generally measured as a function of standard deviation from the mean investment return. Clients should note, however, that there is substantial risk of a permanent loss of capital in most, if not all, asset classes presented herein.

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