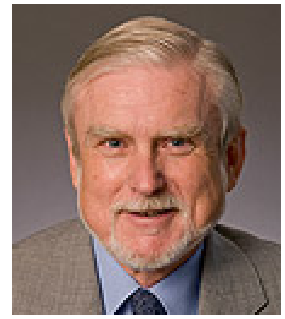
ECONOMIC UPDATE:

Seven Year Expansion



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We continue to expect an acceleration in global economic growth in 2014, above the pace of 2012 and 2013. This should be largely attributable to stronger growth in many developed countries in response to past monetary ease and continuing monetary ease. While there should be a mixed pattern among emerging countries, fears of a developing market crisis appear overdone and continued expansion at a moderate rate can be anticipated in most of them.

We believe the U.S. economy has moved into the second half of what we expect will be seven consecutive years of economic expansion. U.S. real GDP has grown at about 2% over the past four years, but we expect an acceleration to three years of 3% real economic growth in 2014, 2015 and 2016. This should be due largely to the fading of several drags, such as the federal fiscal drag and the state and local downsizing drag. The U.S. is not very inflation-prone, so monetary policy can remain stimulative. The dovish stance of monetary policy was reinforced by the Fed's recent decision to postpone the first taper of QE3.

Europe entered 2013 in a double-dip recession which was caused by the slow pace of financial stabilization in Europe. Aggressive policies and promises from the European Central Bank have, with a lag, calmed these financial stresses. Our view has been that the European recession would end by mid-2013 and be followed by a very weak economic expansion. Recent data have supported that thesis. The swing from a double-dip recession to a modest economic expansion in Europe should contribute to faster global economic growth in 2014 and beyond.

The Japanese economy has been stagnating for two decades, but Abenomics has brought about a dramatic change to a more stimulative policy. Despite uncertainties about the hike in the value-added tax planned for the spring of 2014, confidence and economic activity have improved in Japan, led by a very strong gain in corporate profits which should contribute to future strength in investment spending and wage income.

There was a cost-of-capital shock to many emerging market countries due to volatility in the perceptions of U.S. monetary policy. For countries whose policies are regarded as appropriate, these stresses should calm over time.

China is a separate case. With its capital controls, financial conditions are dominated by domestic decisions rather than by the spillover effects of U.S. economic policy. China is not experiencing a temporary cyclical slowdown. Rather, it is adjusting down to a slower pace of sustainable growth. There has been malinvestment and an accumulation of vulnerable loans in China, but we believe that the Chinese government has both the financial resources and the will to amortize these losses over a number of years, rather than permitting a contagious financial meltdown. We expect an orderly deceleration of trend growth in China.

The Federal Reserve surprised money market participants by deciding to postpone the first taper of its QE3 program of buying $85 billion a month of Treasury and mortgage securities. One reason was that the Fed is "data-dependent" and U.S. economic data have been mixed rather than definitively strong. In addition, the Fed

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appeared concerned about the risk of a fiscal shock. We believe a major motive for the adoption of QE3 in September 2012 was concern about the "tail risk" of a large year-end 2012 "fiscal cliff." In the end, the fiscal tightening was significant but not severe. A year later, we believe that one element in the Fed's decision not to taper in September 2013 was the "tail risk" of disorderly fiscal negotiations over funding the Federal government and the debt ceiling. We believe that the odds of permanent damage are quite low, but there certainly could be some very tense moments between now and early November 2013, when it should all be resolved. We believe that, both in September 2012 and September 2013, the Fed was motivated in part by the desire to take out some monetary insurance against potential fiscal shocks.

We continue to expect a three-phase upward adjustment of bond yields over a half-decade period, as outlined in our report entitled "Interest Rate Normalization" dated September 12, 2013. The first phase is an adjustment to free-market levels from artificially low bond yields, which reflect an artificial scarcity of bonds due to large scale bond purchases under QE3. This adjustment is underway, but in a choppy pattern, due to the Fed's "Hamlet syndrome" about beginning the tapering down of QE3. To taper or not to taper? That is the question. We regard the Fed's failure to start the taper as a leading indicator of a central bank which will eventually end up "behind the curve" in its monetary policy, slowly building up the pressure for a major upward spike in interest rates in 2017 or 2018, following the Presidential election of 2016. While the first Fed taper has been postponed, we expect the first taper to occur within the next two to six months.

The second phase described in our "Interest Rate Normalization" report is a gradual upward drift in free-market interest rates as the growth rate of both nominal GDP and real GDP accelerates and the unemployment rate falls. We expect a third phase of a late cycle upward interest rate spike in 2017, possibly in 2018.

One of the reasons that the unemployment rate has been trending down is that there has been a fall in the percentage of the U.S. population either employed or seeking work. Those who are neither working nor looking for work are not characterized as unemployed. A key economic debate is whether the fall in the participation rate implies a permanent reduction in labor supply (the structural thesis) or is mostly the temporary result of a cyclically weak economy (the cyclical thesis). The main supporters of aggressively easy monetary policy (both on the Fed and outside the Fed) tend to believe that it is mostly cyclical and that a major increase in new jobs would be unlikely to cause a substantial acceleration of wage inflation. Current Federal Reserve policy is based on the thesis that the U.S. economy is not very inflation-prone.

The consensus at the Federal Reserve is that full employment will be reached by the end of 2016, but that the Federal funds rate should then be only 2%, one half of the Fed's estimate of the long-run normal Federal funds rate of 4%. Only time will tell whether that is correct, but the clear consensus at the Federal Reserve is tilted towards a concern about excess unemployment rather than towards a concern about a potential future acceleration of inflation.

This dovish consensus at the Federal Reserve is consistent with ample financial liquidity and a prolonged period of economic growth. We regard Fed policy as fully consistent with our forecast of 3% real GDP growth for the next three years. We believe that current Fed policy is consistent with our "Three for Three" thesis.

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