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+3.0%, +3.0%, +2.9%, +2.8%; -0.1%, -1.8%, -2.9%

Wondering what the string of numbers in our title represents? The first four numbers are the Federal Reserve's (the Fed's) low-end estimates for annual 2014 Gross Domestic Product (GDP) growth published in 2010, 2011, 2012 and 2013, respectively. The final three numbers are the initial, revised, and final GDP estimates for first quarter 2014 published by the Commerce Department. The change from the second revision of -1.8% to the final revision of -2.9% is the biggest since records began in 1976. We believe this string of numbers justifies the low confidence attributed to the Fed's long-term projections and illustrates the challenge of measuring and projecting economic activity, even in the short-term.

Are we headed for a recession? NO.

Why do we have such strong conviction? There are many reasons:

- The first quarter GDP growth number was an anomaly. Personal consumption, which accounts for two-thirds of GDP, was actually up 1%; however, the less predictable components (inventories and exports) drove the headline number down. The implementation of the Affordable Care Act and, most importantly, the weather also distorted economic growth. Other data points, to be discussed in greater detail herein, do not imply continued contractions. We anticipate a nearly offsetting, positive GDP growth number for the second quarter of 2014.
- According the Bureau of Labor Statics (BLS), there is less slack in the labor market than there has been since approximately 2005. The number of available people per job opening is back to its pre-crisis average of 4 people per every job opening down from 10 per every job opening in 2008. Unemployment and underemployment conditions are improving, and weekly initial jobless claims are now back to pre-recession levels in the low 300,000 area.
- Existing and new home sales continue to improve. Months of supply for existing homes now equal 5.6 months. The National Board of Realtors considers 6 months of supply to be equilibrium where neither buyer nor seller has an upper hand in negotiations. The number of distressed sales as a percentage of total sales was last reported at 11%, the lowest level since 2008. First time home buyers are slowly returning to the marketplace. As a percentage of total sales, first-timers typically represent 40% of sales. Currently, they only represent 27% of total sales. We anticipate this number to slowly improve along with the labor market but do not expect the percentage to return to pre-crisis levels as financing options for first time homes buyers have been dramatically reduced.
- The most recent "Summary of Commentary on Current Economic Conditions", also known as the "Beige Book" published by the Fed, noted that lending activity increased in all twelve Fed districts. Commercial and industrial loans grew and auto loans continued to grow on the consumer side as well. Only the New York and Richmond Fed districts reported declines in residential mortgage lending. As reported in our first quarter commentary, the Small Business Administration reported continued improvement in small business lending. It is important to note, however, that according to the Census Bureau Business Dynamic Statistics Unit, the number of startups created in 2011 (the last year information available) is about 30% lower than in the 1980's. Why is this? Simply, the aging of America as the Baby Boomer generation has moved from being entrepreneurs to the stability of retirement. The Great Recession in 2008 only further encouraged a behavioral shift away from risk-taking activity. We expect small business lending to continue to improve as more banks slowly ease lending standards, potentially resulting in more Echo Boomers catching the American entrepreneurial spirit.
- Inflation remains in check both domestically and internationally. As a result, we do not expect the Fed to change its position on short term rates until the latter part of 2015 or early 2016. The tapering program for Quantitative Easing III (QE3) will remain on track for completion in the fourth quarter. European bankers are concerned about disinflation, rather than inflation, resulting in record low Euro zone government bond yields. We discuss the impact of their efforts on the 10-year U.S. Treasury note in greater detail later in this letter.
- We anticipate the very important, but slow to revive, commercial construction sector to improve later this year. The design industry snapped out of a two-month decline with a three-point jump in the AIA's Architecture Billings Index (ABI) last month. The AIA reported the May ABI score was 52.6, up considerably from April's score of 49.6. (An index score above 50 indicates growth, whereas a score below 50 indicates contraction.)

The score for new project inquiries has been steadily increasing for the past four months. May's value was 63.2, up from 59.1 in April. The numbers in this category have been in positive territory (over the 50-point line) since February 2009. The score for design contracts in May was 52.5, a decrease from April's 54.6, but still reflecting growth in the category. The AIA debuted the ABI economic indicator in their March report to more accurately evaluate future growth within the industry. Always seeking new ways to further strengthen our forecasts, Oppenheimer Investment Management added this measure to the long list of economic indicators we monitor.

The US Treasury rate versus other developed country rates

One of the factors keeping U.S. interest rates low is the coordinated low interest rate policies being enacted by central banks around the world. Driven by the perception of low global inflation and a fear of possible deflation, central banks in both Europe and Asia have enacted policies to drive local interest rates lower across the maturity spectrum. At the beginning of June, the European Central Bank (ECB)

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announced a package of measures, including cuts to its policy (short-term) rates as well as negative interest rates on deposits at the central bank. As with the U.S., the European Union is attempting to spur loan growth and resulting economic activity by driving interest rates lower. Below is a chart detailing quarter-end yields and year-to-date trading ranges for major sovereign bonds.

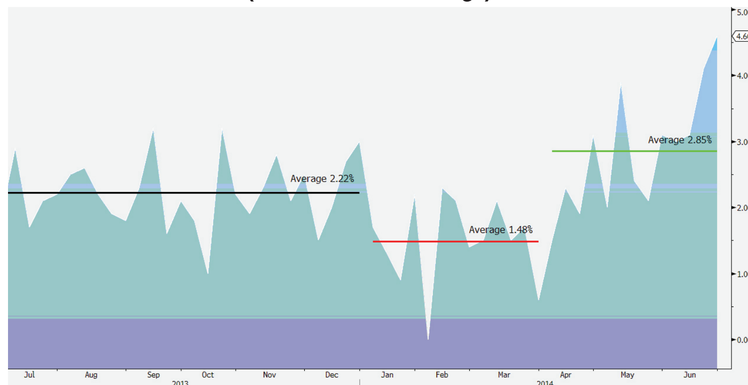
Country	10 Year Gov't Yield (As of June 30, 2014)	High Yield (Year-to-Date)	Low Yield (Year-to-Date)
United States (Aaa/AA+)	2.53%	3.00%	2.44%
United Kingdom (Aa1/AA+)	2.66%	3.02%	2.52%
France (Aa1/AA+)	1.69%	2.56%	1.68%
Germany (Aaa/AAA)	1.24%	1.94%	1.24%
Spain (Baa2/BBB)	2.65%	4.10%	2.56%
Italy (Baa2/BBB+)	2.84%	4.04%	2.70%
Greece (B-/B)	5.85%	8.41%	5.47%
Japan (Aa3/NR/A+)	0.55%	0.73%	0.55%

Source: Bloomberg Markets

In Typical Fashion, the Consumer Will Lead the Way

Challenges facing U.S. consumers were well documented in 2013, and included payroll tax increases, the QE3 taper tantrum and federal government shutdown. Consumer spending in early 2014 has proven to be even weaker due to harsh winter weather keeping shoppers out of stores, higher energy bills and increases in out-of-pocket healthcare costs. However, we may be seeing signs of a "thaw" in consumer spending in the second quarter. One data point that has caught our attention is the International Council of Shopping Center's U.S. Chain Store Sales Index. As seen in the chart below, year-over-year increases in weekly retail sales averaged 2.22% during the second half of 2013. The average slipped to 1.48% growth in the first quarter of 2014 but accelerated in second quarter to 2.85%, exiting the last week of June with a 4.60% year-over-year increase – the largest weekly increase since 2011. While underemployment and tepid discretionary income growth remain concerns, we believe job gains, a slowing in consumer deleveraging and the wealth effect from rising stock and home prices will prove to be tailwinds for consumer spending growth as we move into the back half of 2014.

ICSC Weekly U.S. Retail Chain Store Sales Index (Year-Over-Year Change)



Source: Bloomberg

Finally, as we enter the sixth year of economic recovery, we believe things may really be different this time. The typical economic recovery lasts about 5 to 6 years before they are snuffed out by higher interest rates imposed by the Fed to head-off future inflation. The tepid pace of the current recovery, the Fed's expansive balance sheet and market involvement, and the Fed's tolerance of temporarily higher inflation to avoid stagnation and possible deflation portend a materially longer recovery cycle than normal.

Capital Markets and Performance

The taxable fixed income market in the second quarter of 2014 experienced lower interest rates as doubt lingered over the strength of the U.S. economic recovery. The bellwether 10-year Treasury yield declined 19 basis points during the quarter to close at 2.53%. The Barclays Capital U.S. Aggregate Index returned 2.04% for the quarter and 3.93% year-to-date. As fixed income investors continue their search for yield, corporate securities were the best performers in the quarter at 2.66% and 5.68% year-to-date. Treasury securities lagged at 1.35% for the quarter and 2.72% year-to-date. Longer maturities outperformed shorter maturities as interest rates declined and lower quality bonds outpaced higher quality. High Yield performance as measured by the BofA/Merrill Lynch High Yield Master II Index returned a strong 2.57% in the quarter and 5.64% year-to-date.

We are very pleased to report that on a year-to-date basis, all of our composites outperformed their respective benchmarks. As the U.S. economy continues its recovery, we will remain overweight corporate securities as we believe they continue to offer the best relative value in fixed income. In addition, we will keep portfolio durations shorter than our respective benchmarks in anticipation of interest rates drifting higher later this year.

While all markets are currently trading on the latest economic releases, please remember our bottom-up investment process and extensive research focus helps to increase our understanding of our fixed income positions and helps us identify relative value opportunities. While never losing sight of the global economic environment, our long only style of investing has delivered positive results with reduced volatility. If you have any questions on strategy, performance or business development, please do not hesitate to contact us.

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