

Q2 2015 LOOK AHEAD

Disclaimer

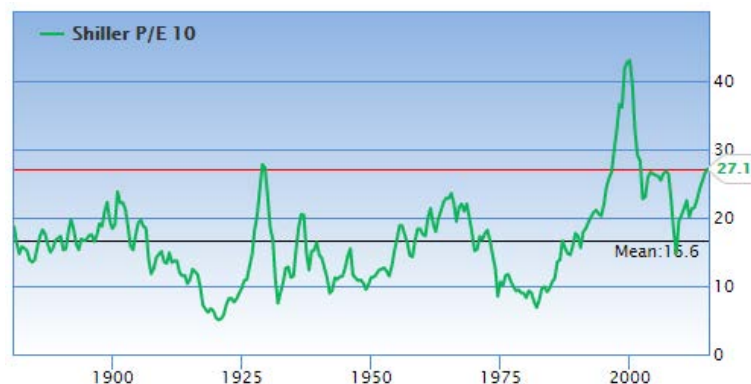
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First Things First: Are Stocks Overvalued?

- The S&P 500's 10-year CAPE ratio (Cyclically-Adjusted Price-Earnings) is at one of its highest levels, but only 6.7% above its 25-yr average.

Shiller P/E Historical Avg:

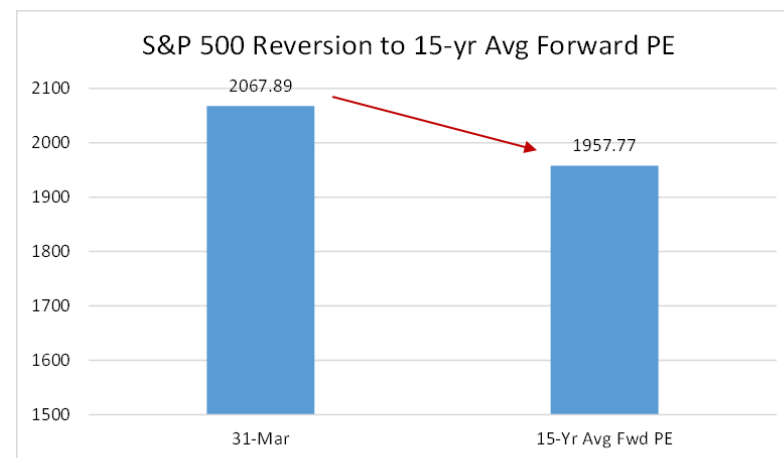
- 10-yr = 22.9
- 25-yr = 25.4



- US stocks have high valuation relative to their historical forward P/E, due in part to financial repression.

Asset Class	CAPE	Fwd PE	10-yr Avg Fwd PE	Fwd PE % of Avg
United States	28.8	17.1	14.0	122%
International Developed	21.1	15.9	12.7	125%
Emerging Markets	15.8	11.9	11.2	106%

- The mean reversion on the S&P 500 would be about -5.3%, based on estimated earnings growth of 11.8% in the next 12 months.



*Based on 3/31/15 S&P Close and Fwd PE of 16.9, and 15-yr average Fwd PE of 16.0.

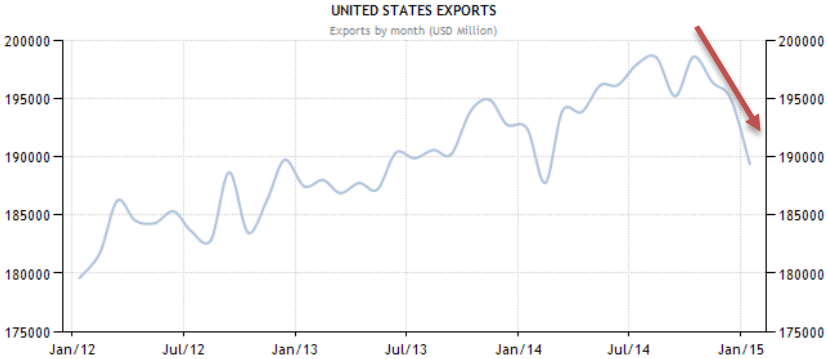
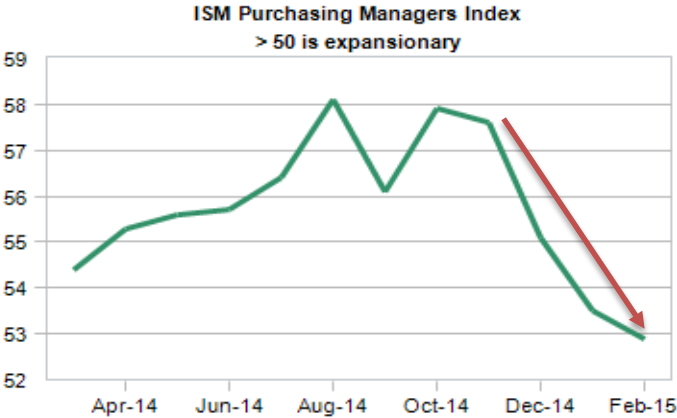
- This quarter's main question: Will earnings support this valuation?**

Sources:

GuruFocus.com. (4/2/15). Shiller P/E.
 JP Morgan. (3/31/15). 2Q 2015 Guide to the Markets. p 5, 9, 52.
 Star Capital. (4/2/15). Global Stock Market Valuation Ratios.
 Yahoo Finance. (3/31/15). S&P 500 Closing Price.

Strength and Weakness: The Economic Impact of a Strong US Dollar

- The US Dollar has risen strongly against the Euro and the Yen, making US products more expensive to overseas markets.
- Exports have declined, and manufacturing and GDP growth are slowing.
- Manufacturing accounts for 12% of US GDP and supports 17.6 million jobs (1-in-6 private sector jobs).



SOURCE: WWW.TRADINGECONOMICS.COM | U.S. CENSUS BUREAU



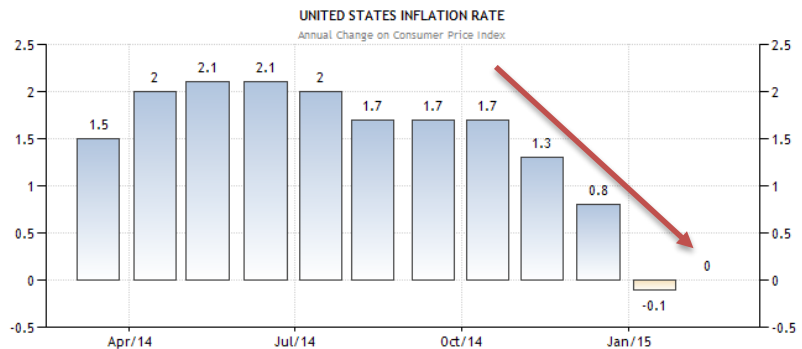
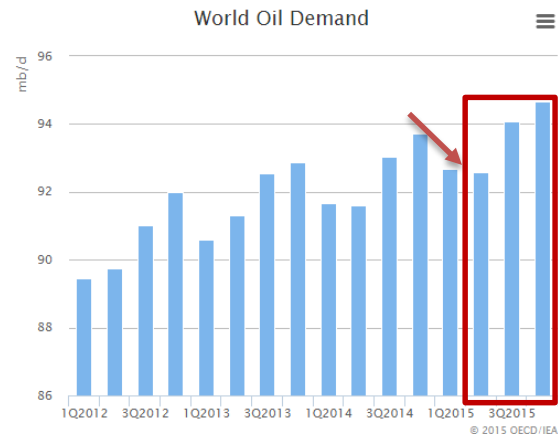
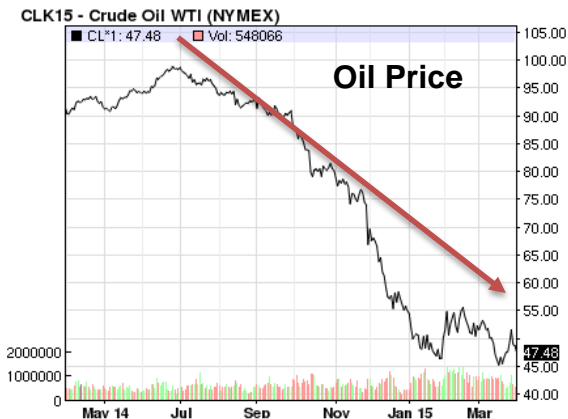
SOURCE: WWW.TRADINGECONOMICS.COM | U.S. BUREAU OF ECONOMIC ANALYSIS

Sources:
 National Association of Manufacturers. (2014). Facts about Manufacturing.
 Google Finance. (3/31/2015). Currency Chart.
 TradingEconomics.com. (3/31/2015). United States Exports.
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 TradingEconomics.com (3/31/2015). US GDP Annual Growth Rate.



Energy Prices – Challenges and Benefits

- Low crude oil prices have negatively impacted energy company earnings. Energy producers are reducing CapEx and focusing on lower-cost wells. In 2014, Energy companies contributed 11% of 2014 S&P 500 earnings.
 - On average, producers have hedged ~31% of 2015 production at ~\$83.80 per barrel.*
- World oil demand has declined and is not expected to rebound until the second half of 2015.
- US consumers are benefiting from lower fuel costs and low inflation, but are saving instead of spending.



SOURCE: WWW.TRADINGECONOMICS.COM | U.S. BUREAU OF LABOR STATISTICS

SOURCE: WWW.TRADINGECONOMICS.COM | U.S. BUREAU OF ECONOMIC ANALYSIS

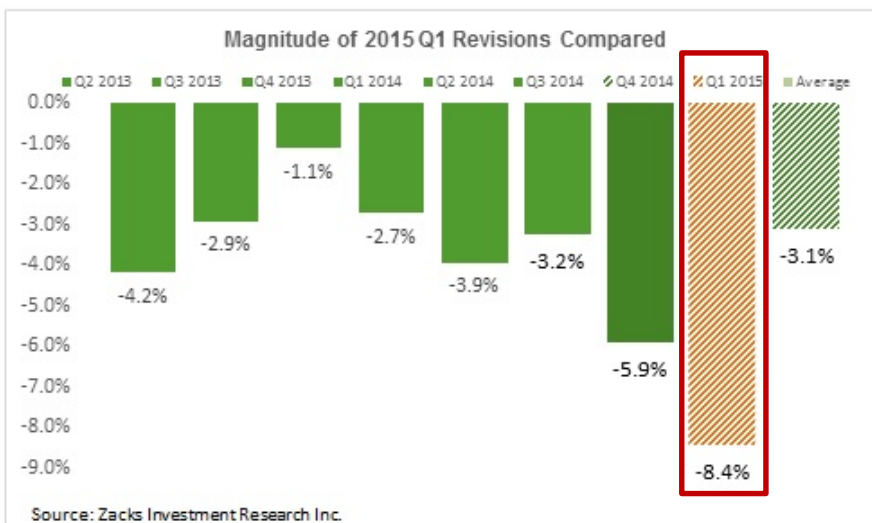
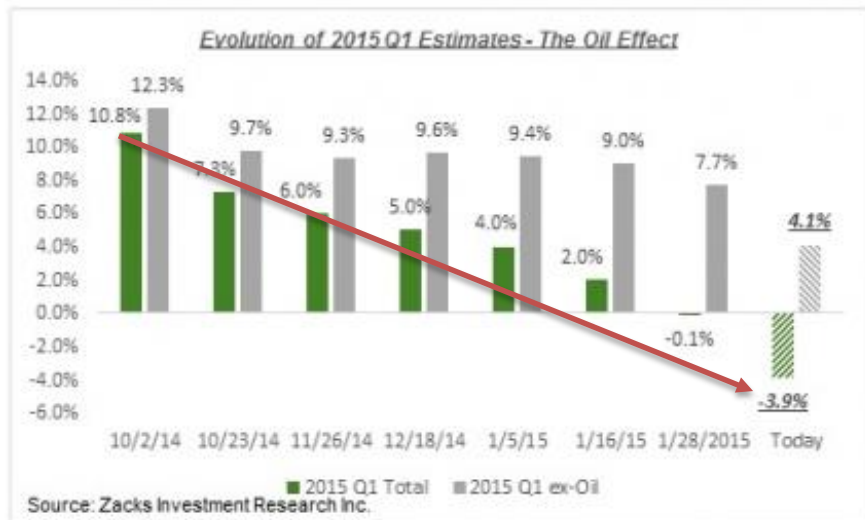
*Average hedging estimate and price from Simmons & Co. International, which tracks about 40 producers.

Sources:
 Friedman, N. and Ailworth, E. (3/26/2015). Oil Companies Reap Large Gains After Cashing in Hedging Bets. Nasdaq.com. (3/31/15). Crude Oil WTI Price.
 IEA. (3/13/15). Oil Market Report. World Oil Demand.
 TradingEconomics.com. (3/31/15). United States Inflation Rate.
 TradingEconomics.com. (3/31/15). United States Personal Savings Rate.
 S&P Dow Jones Indices. (4/2/15). S&P 500 Earnings and Estimate Report.



Q1 Earnings: Opportunity to Exceed, Unlikely to Disappoint

- Analysts' consensus Q1 S&P 500 earnings growth estimates have declined sharply since October 2014.
- Excluding energy companies, earnings growth is estimated at 4.1% down from 12.3%.
- The magnitude of the negative revisions is the largest in recent quarters and nearly 3 times the 7-quarter average.
- CFO's slightly optimistic – average Q1 guidance of 9.2% below analyst expectations vs 5-yr average of 11.3% below.



- **Can Wall Street tell the difference?**
- **Is there an opportunity to surprise to the upside?**

Sources:

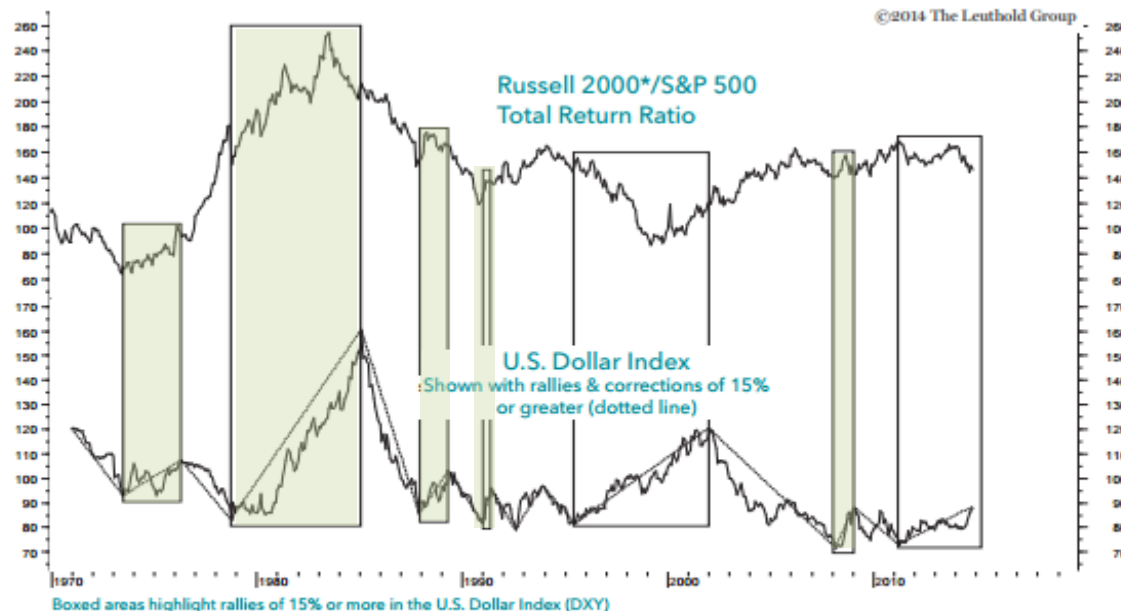
Mian, S. (3/27/2015). Are Negative Q1 Earnings Revisions Unusual? Zacks. Graphs reflect Zacks consensus analyst estimates for S&P 500 companies.

Butters, J. (3/31/2015). Guidance S&P 500. FactSet.

Small Cap Stocks and the Dollar

- During periods of dollar increases of 15% or more, Russell 2000 small caps achieved an annual total return of 13.6% versus 10.7% for the S&P 500 large caps.
- Foreign-generated revenues account for 46% of S&P 500 company sales compared to <20% for Russell 2000 small-cap company sales.
- From 8/1/14 to 3/31/15, the Russell 2000 gained 12.9% versus 8.6% for the S&P 500.

SMALL CAP LEADERSHIP AND THE DOLLAR



Boxed areas highlight rallies of 15% or more in the U.S. Dollar Index (DXY)

*Ibbotson Small Company Stock series used from 1970-78

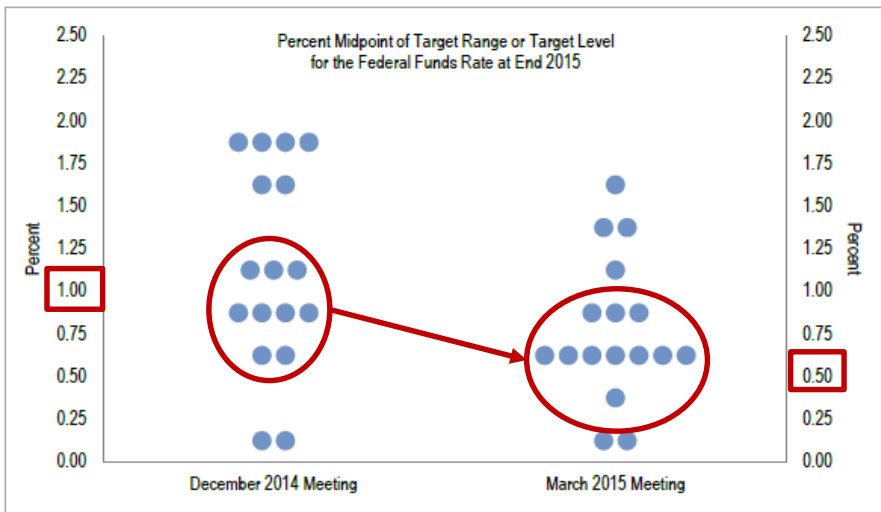
*The chart depicts historical differences in total return between small-cap stocks (Russell 2000 Index) and large-cap stocks (S&P 500 Index) as compared to movements in the U.S. Dollar Index, dating back to 1970. The top line represents the return ratio of the Russell 2000 Index to the S&P 500 Index; or the return of the Russell 2000 Index divided by the return of the S&P 500 Index. The bottom line represents the U.S. Dollar Index. The boxed areas highlight rallies of 15% or more in the U.S. Dollar Index (DXY).

Sources:

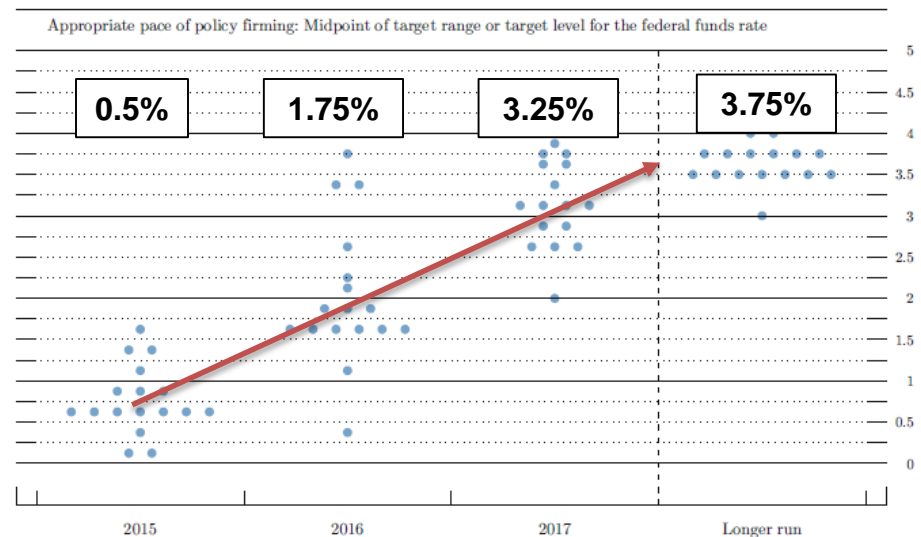
Perritt Capital Management. (2015). Dollar Strength and Small Cap Stock Returns.
 Sagami, T. (2/3/15). Procter & Gamble, the Strong Dollar, and Pepto Bismol. Mauldin Economics.
 Park, Y. (4/29/13). Worried About World Economy? Bet on US Small Caps: Goldman. CNBC.
 Morningstar Direct. (8/1/14 to 3/31/15). S&P 500 and Russell 2000 returns.

The Fed Gets Ready to Wait

- The Fed's recent policy statement cleared the way for future interest rate increases, however Fed Chair Janet Yellen said,
 - “Just because we removed the word ‘patient’ doesn’t mean we are going to be impatient.”
- Fed rate hikes will be driven by economic data, which has been weak and inflation is low.
- The Fed's median 2015 target rate was lowered to 0.50% from 1.00%.
- A global slowdown and low international rates could keep US interest rates lower for a longer timeframe.



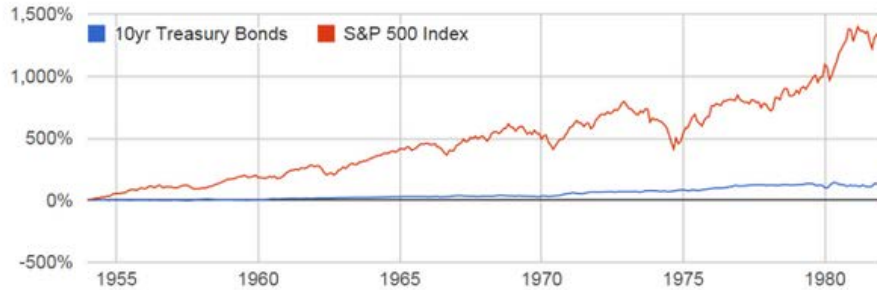
Source: Federal Reserve Board as of March 2015.



Sources:
 Goldman Sachs. (3/20/15). Market Monitor.
 Federal Reserve Board. (3/18/15).

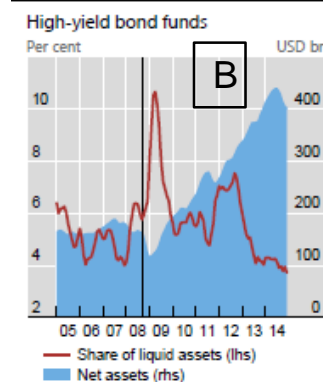
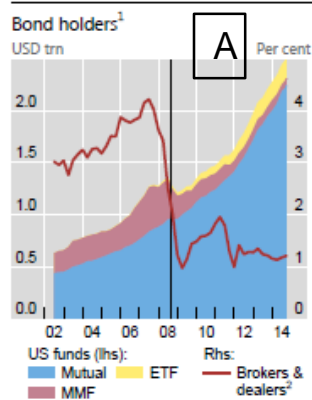
Fixed Income: Don't Fear Bonds, Fear Liquidity

- From 1955 to 1981, when 10-yr interest rates rose to 15.13%, 10-yr Treasuries returned 3% annually.



Source: Yahoo Finance, Federal Reserve, Hedgewise Internal Analysis

- In the 2013 Taper Tantrum, Treasury and High-Yield rates rose sharply in a matter of weeks. Longer-term bond prices declined more than shorter-term bonds.



- Total corporate bond assets are at a record high [A], while trading volume and dealer inventories decline, and high-yield funds have a lower share of liquid assets [B].

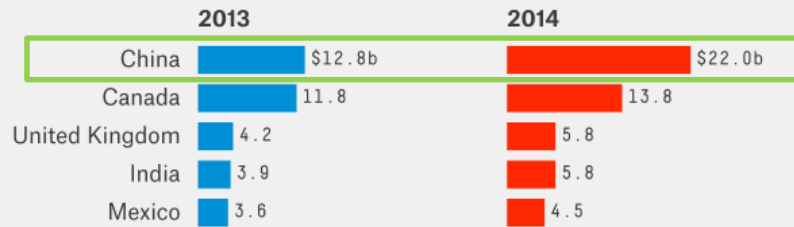
Sources:
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Google Finance. (4/2/15). Bond ETF data from 5/21/13 to 7/5/13.
Fender, I. and Lewrick, U. (March 2015). BIS Quarterly Review.

Foreign Markets – Be Selective

- Greece faces reality and plays brinkmanship while the EU defends the Euro.
 - “The ECB is ready to do whatever it takes to preserve the Euro.” (ECB President Draghi, 2012)
- The strong dollar may fuel China to invest more in US Treasuries/Real Estate and propel its export-sensitive economy.
- Japan’s reforms are not gaining traction on inflation.
- Brazil may have turned the corner on GDP growth.
- Russia is destabilized with no path to recovery. Foreign lenders have reduced exposure to Russia.

Sales of U.S. Real Estate to Foreign Buyers

By country of origin

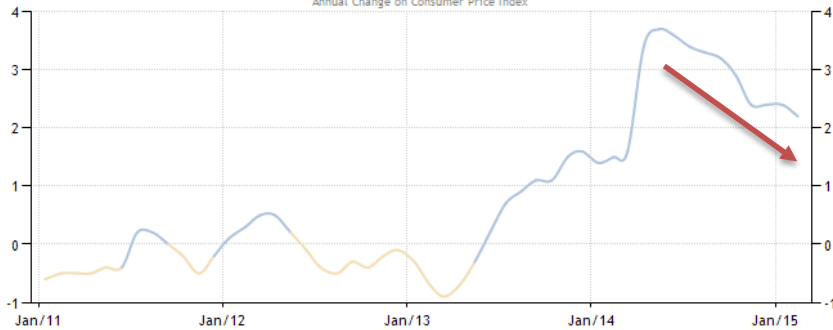


FIVETHIRTYEIGHT

SOURCE: NATIONAL ASSOCIATION OF REALTORS

JAPAN INFLATION RATE

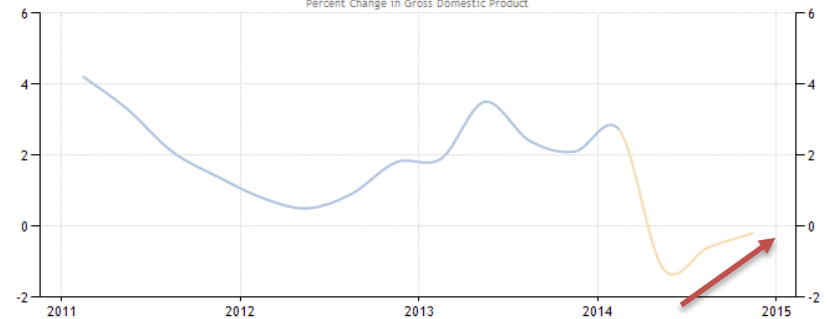
Annual Change on Consumer Price Index



SOURCE: WWW.TRADINGECONOMICS.COM | MINISTRY OF INTERNAL AFFAIRS & COMMUNICATIONS

BRAZIL GDP ANNUAL GROWTH RATE

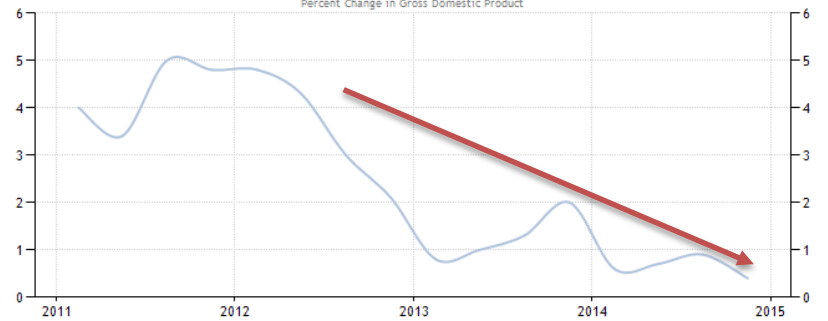
Percent Change in Gross Domestic Product



SOURCE: WWW.TRADINGECONOMICS.COM | INSTITUTO BRASILEIRO DE GEOGRAFIA E ESTATÍSTICA (IBGE)

RUSSIA GDP ANNUAL GROWTH RATE

Percent Change in Gross Domestic Product

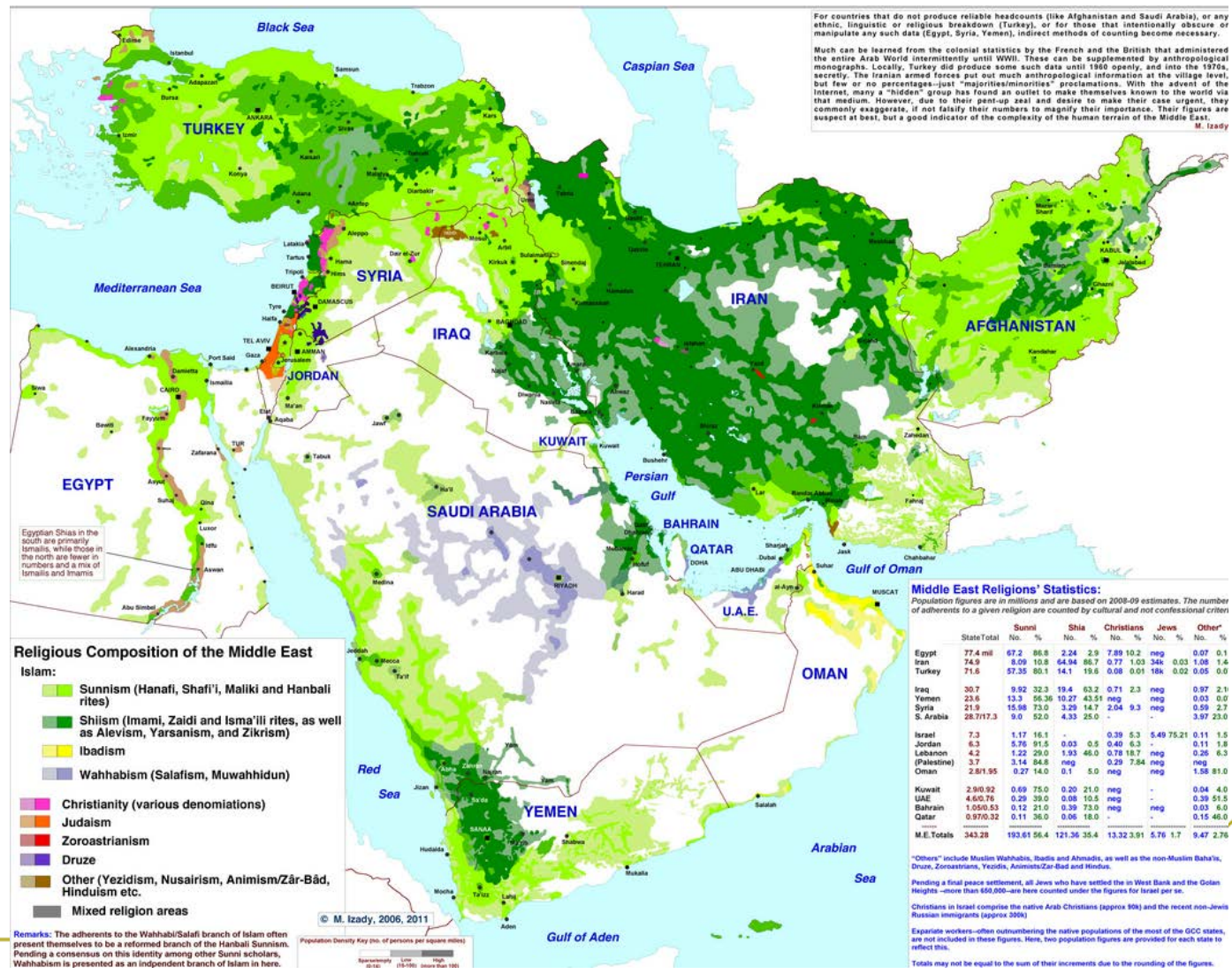


SOURCE: WWW.TRADINGECONOMICS.COM | FEDERAL STATE STATISTICS SERVICE

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 Flowers, A. (7/11/2014). Why the Chinese Are Snapping Up Real Estate in the U.S. FiveThirtyEight.
 TradingEconomics. (4/1/15). Japan Inflation Rate, Brazil GDP Growth Rate, and Russia External Debt.

Middle East Interfaith Turmoil – Scary and Small for Now

- If Middle East turmoil impacts oil production, higher energy prices could slow global growth.
- The Middle East region* represents about 5% of the world's GDP with projected average GDP growth of 3.5% (2015) and 4.1% (2016).
- The Middle East region* produces 31% of the world's oil.



*Includes: Egypt, Turkey, Syria, Jordan, Iraq, Saudi Arabia, Kuwait, Yemen, Oman, UAE, Bahrain, Qatar, Iran, Afghanistan, Lebanon, and Israel. No GDP data available for Syria.

Sources:
 TheSinoSaudiBlog. (May 2011). Wordpress.
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 Knoema.com. (Oct 2014). IMF World Economic Outlooks. GDP (in US Dollars, billions).
 International Monetary Fund. (Oct 2014). World Economic Outlook: Global Data.



Mean Reversion Dashboard

Regional Fwd P/E as a % of 10yr Avg. Fwd P/E

ACWI	EAFE Index	EM Index	United States	Germany	U.K.	China	Brazil	India	Russia
122.1%	125.2%	106.3%	122.1%	123.2%	133.0%	89.7%	119.6%	112.0%	73.0%

Style Current P/E as a % of 20yr Avg. P/E

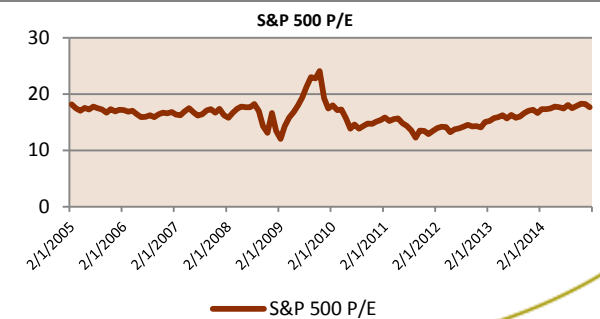
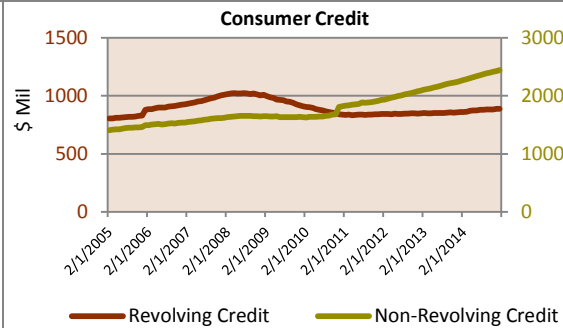
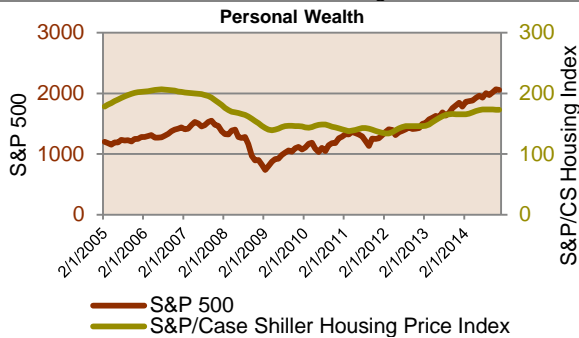
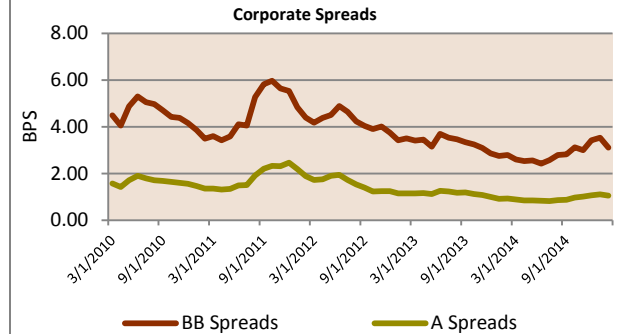
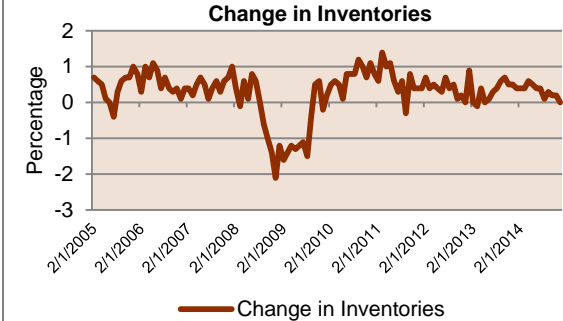
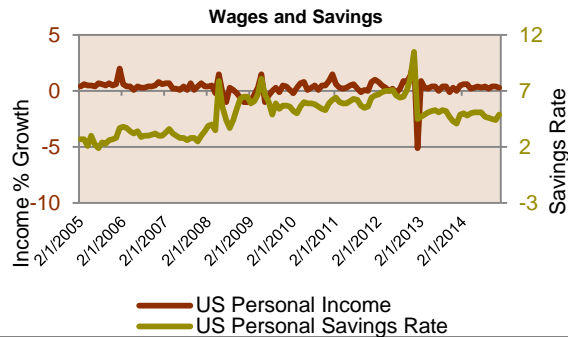
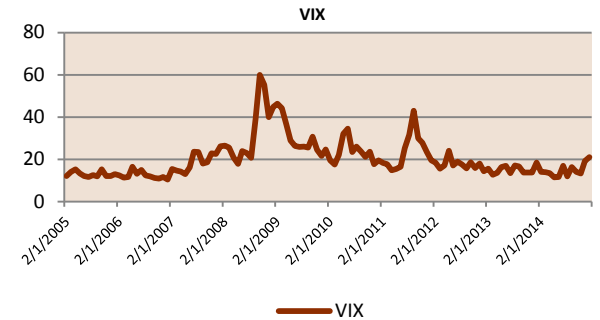
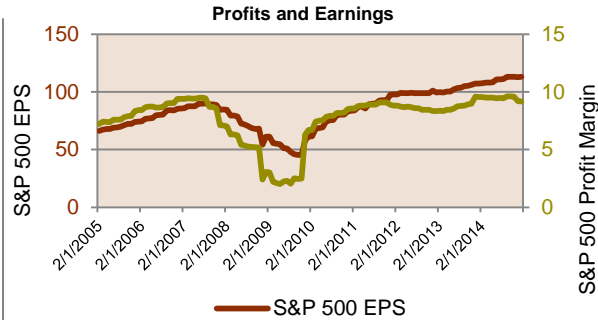
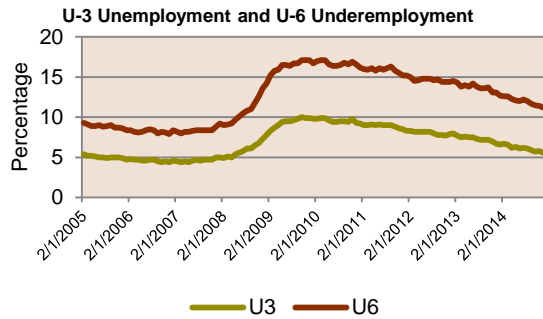
	Value	Blend	Growth
Large	116.4%	104.3%	91.7%
Mid	124.4%	118.1%	98.5%
Small	114.3%	107.1%	97.4%

Sector Trailing P/E as a % of 20yr Avg. P/E

Financials	Technology	Health Care	Industrials	Energy	Cons. Discr.	Cons. Staples	Telecom	Utilities	Materials
100.0%	70.6%	98.3%	91.6%	76.9%	105.7%	107.5%	118.5%	125.2%	108.2%

Source: JP Morgan Asset Management. (Mar 31, 2015). "2Q 2015 Guide to the Markets", p. 8-9, 52-53. JP Morgan sources data from MSCI, FactSet, Standard & Poor's, Russell Investment Group, and J.P. Morgan Asset Management. Trailing P/E ratios are bottom-up values defined as month-end price divided by the last 12 months of available reported earnings. Historical data can change as new information becomes available. Past performance is not indicative of future returns.

Economic Dashboard



Source: Bloomberg LP and Federal Reserve. Data is from sources deemed to be reliable. No representation or warranties either expressed or implied are made as to the accuracy of the information presented. Data retrieved on 3/31/2015.

Summary

- Expect interest rates to rise in late 2015, but by less than previously anticipated.
- The strong US dollar is slowing exports and GDP growth.
- Q1 earnings expectations are weak due to the dollar and low energy prices.
- US consumers are saving more – will they start spending?
- Be selective in foreign markets.
- Don't fear bonds, fear liquidity.
- **Earnings are the critical factor.** If expectations are not met, there could be a dramatic negative effect as the market is fully valued to meet expectations.

Recommendations:

- Continued weighting to the US with tilts toward US Small and Micro Caps due to the strong US dollar.
- Increase exposure to exporters like Germany and China.
- Buy Emerging Markets growth in India, China, Brazil, and Indonesia. All are demonstrating a drive to a consumer-focused economy.
- In Fixed Income, actively manage duration, potentially extend beyond the Barclays Aggregate Bond Index duration of 5.5 years.

THANK YOU

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