

Executive Summary

- Economic growth should continue at above-trend levels in 2015, abetted by consumer and business spending and continued labor-market improvement.
- Auto sales remain a bright spot and strong tailwind for a manufacturing sector that took a bit of a breather toward the end of 2014 but should pick up.
- The Fed appears wedded to tightening despite more easing elsewhere and virtually no hints of domestic inflation. But any rate increases are likely to be muted and measured.
- Housing could be the upside surprise of 2015, as extremely low mortgage rates and a stronger job market push hesitant Millennials into the home-buying market.
- The downside of lower oil prices appears to be hitting first but over the longer term, the likelihood is lower oil's positives will overwhelm the negatives in our energy-consuming country.
- We are overweight stocks in our stock-bond model, have a 2,350 target on the S&P 500 for 2015 and, in bonds, favor commercial MBS and investment-grade and high-yield corporates.

2015 Outlook: Now *this* is a recovery

With tightening on the horizon, the eurozone barely growing and China slowing, the New Year will bring challenges. But fundamentals suggest the U.S. economy reached liftoff about mid-year 2014, prompting Federated strategists to set a 2,350 price target on the S&P 500 for 2015 and, in fixed income, to favor high-yield, investment-grade and commercial mortgage-backed securities (MBS), all of which are more closely aligned with the economy and less sensitive to interest-rate changes than government bonds.

Last year's brutal winter that brought an accelerating economy to a halt has faded with the polar vortex. Real 2014 second- and third-quarter gross domestic product (GDP) rebounded a respective 4.6% and 5.0%—the best six-month spurt in 11 years—and growth is expected to remain robust and above-trend this year, driven by nonfarm payrolls that expanded in 2014 by the most in 15 years, auto sales that are running at their highest sustained pace in eight years, a manufacturing expansion that has pushed capacity utilization to levels historically conducive to increases in capital spending, and a consumer who doesn't appear exhausted despite spending relatively freely over the holidays.

Once the final tally is in, Federated's macroeconomic policy committee projects GDP will have expanded at a healthy and above-consensus 3.6% rate in 2014's fourth quarter, putting growth for the year at 2.4%. Despite struggles elsewhere, uncertainty over the positives and negatives of lower oil and a Federal Reserve (Fed) that seems intent on initiating higher rates even in the face of unprecedented European easing, this growth is projected to carry over into 2015. While there are signs of early-year softening, full-year real GDP is forecast to reach 3.4% for all of 2015, with lower oil's payoff gradually picking up as consumers grow comfortable with the idea cheap gas isn't going away, prompting them to spend more and save less of their "energy dividend." Combined with low inflation and still-low rates, this should keep the equity rally going but be problematic for Treasury securities, particularly on the longer end. While just about everyone was wrong about long rates last year—we projected them to move up over the course of 2014 to 3.25–3.50%; instead, they fell—it's difficult to see 10-year yields remaining at sub-2.0% levels in a year promising stronger growth and the first Fed tightening in nine years.

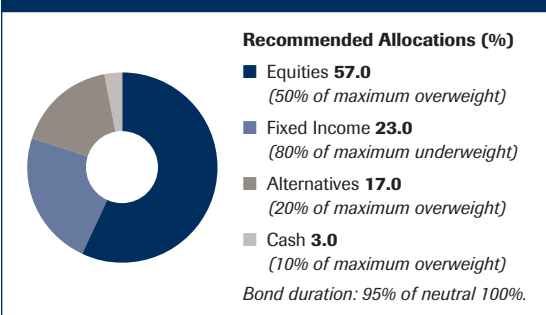
GDP on the Rise

	2014	2015
First Quarter	-2.1%	3.0%*
Second Quarter	4.0%	2.8%*
Third Quarter	5.0%	3.2%*
Fourth Quarter	3.6%*	3.2%*
Total	2.4%*	3.4%*

Source: Federated.

* Federated projections.

Federated Moderate Growth Model



Source: Federated, as of January 21, 2015.

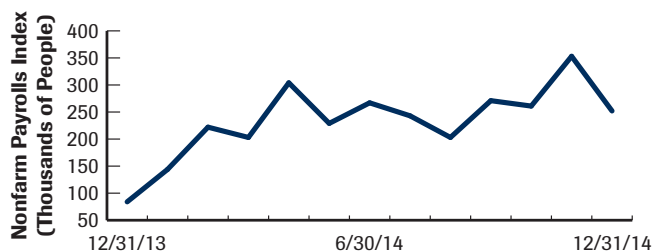
We believe the macro scenario will continue to support our overweight stocks/severe underweight bonds call in our benchmark moderate growth stock-bond portfolio models. Even though we recently lowered our overweight equities to half from 80% of the maximum, that was done primarily to capture gains on last year's equity run-up and to keep some powder dry so that we can average back in at more attractive levels during inevitable market pullbacks. Simply put, we think this bull has more room to run while government bonds may be enjoying their last gasp before potentially entering a prolonged though potentially muted sell-off.

Job gains broaden and accelerate

December's 252,000 gain in nonfarm payrolls—an upward revisions totaling 50,000 the prior two months—closed out the best year for job growth since the go-go 1990s and dropped the unemployment rate to a six-year low of 5.6%. Unlike previous job recovery years, the bulk of the new jobs in 2014 were full-time and good-paying—a Bloomberg BusinessWeek analysis of Labor Department data found 66% of all jobs created in 2014 were in businesses that provided above-average paying positions, including accounting firms, consultants, computer system designers, construction companies and manufacturers.

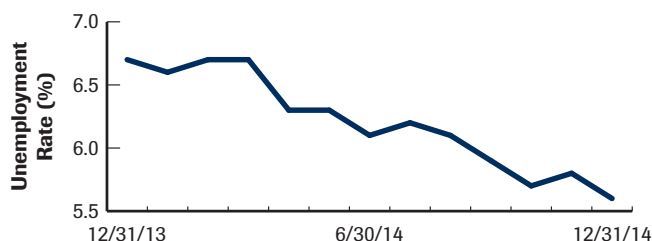
Wages remain problematic, however. After perking up in late fall, they fell back again in December and November's gains were trimmed. The lack of real wage growth, combined with a disappointing labor-force participation rate and a still relatively high level of discouraged and underemployed workers, are blemishes on the otherwise improving labor-market picture. If there's an upside to the discouraging wage and participation metrics, it is that they give a data-dependent Fed room to be patient on the tightening front.

Nonfarm Payroll Changes: 12/31/13-12/31/14



Source: Bloomberg, as of 12/31/14.

Unemployment Rate: 12/31/13-12/31/14



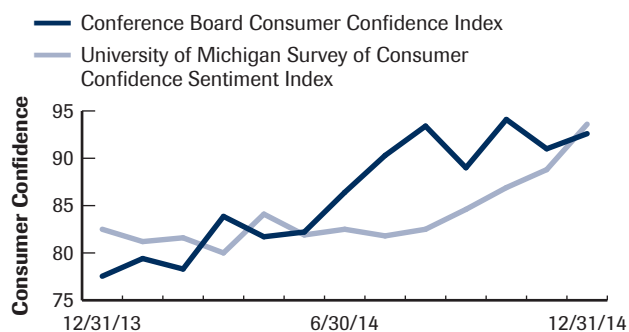
Source: Bloomberg, as of 12/31/14.

Consumer mood brightens

The improving job market, combined with sharply lower gasoline prices, is fueling a resurgent consumer. The University of Michigan's Consumer Sentiment index and its expectations component hit 11-year highs in mid-January, while the Conference Board's confidence gauge is at a seven-year high. This optimism is showing up at auto dealer showrooms, furniture, electronics and appliance stores and luxury outlets. While the initial read on December retail sales unexpectedly fell 0.9%, the drop-off in this highly volatile metric assuredly was exacerbated by several factors, including the heavy use of gift cards which acted to depress sales but should boost them in January as cards are redeemed—a key reason we tend to view the holiday sales season as a three-month event; the steep falloff in gas prices which caused gas station sales to plunge 6.5%; and extremely robust November auto sales—they were just off an eight-year high, making monthly comparisons difficult.

An arguably better take on consumer spending is discretionary sales, which rose 5.8% year-over-year. Our friends at RDQ Economics also note December typically is fraught with difficult seasonal adjustments, i.e., core retail sales fell 0.4% seasonally adjusted but jumped 22% on an unadjusted basis, the strongest December in three years. The National Retail Federation's tally also showed December sales rising the most in three years. All of this isn't to excuse the disappointing initial December read but to suggest once all the numbers come in, they will reflect a more free-spending consumer, aided by falling gas prices that are estimated to have put an extra \$165 billion in their pockets over the past seven months (the rule of thumb is each 1-cent decline in gas prices adds \$1 billion to consumer discretionary purchases).

Consumer Confidence: 12/31/13-12/31/14



Source: Bloomberg, as of 12/31/14.

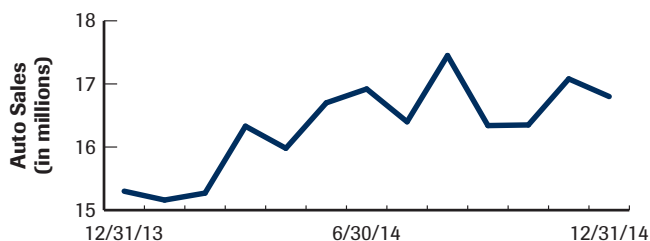
Manufacturing moderates

Robust auto sales are helping buttress manufacturing, but factory activity moderated as the New Year approached. On the auto front, sales slipped a tad in December but had their best year since 2006 and appear on course to remain at the elevated 17 million range for some time as the industry plays catch-up due to the advanced age of the U.S. auto fleet (11 years currently vs. 7.5 years on average). The plunge in gas prices also is a plus for automakers, as more

and more consumers are worrying less about fuel efficiency and more about roominess and safety, with bigger, higher-margin trucks and SUVs experiencing a surge in sales. Financing also is at its best level in more than six years.

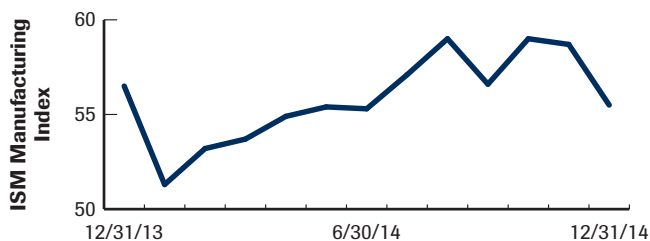
Even with the tailwind from autos, manufacturing slowed somewhat in the waning months of 2014, possibly reflecting both a breather after the summer/early fall spurt on the heels of last winter's slowdown and the initial impacts of falling oil on capital expenditures (capex) by energy companies (energy capex accounts for nearly 10% of total capex). After surging nearly 11% in July, primarily on volatile orders for civilian aircraft, factory orders pulled back in the subsequent months; nondefense capital goods shipments ex-aircraft, which feed directly into GDP, were choppy going into the New Year; and regional manufacturing gauges were mixed. But business inventories continued to expand, reflecting a restocking cycle that began last summer. Industrial production and capacity utilization remained on a solid uptrend, with the manufacturing component rising significantly in 2014's final four months. And a good capex indicator, the Equipment Leasing and Finance Industry's monthly confidence gauge, hit a nearly four-year high this January, with respondents expecting a record year for equipment finance.

Annualized Auto Sales: 12/31/13-12/31/14



Source: Bloomberg, as of 12/31/14.

Manufacturing: 12/31/13-12/31/14



Source: Bloomberg, as of 12/31/14.

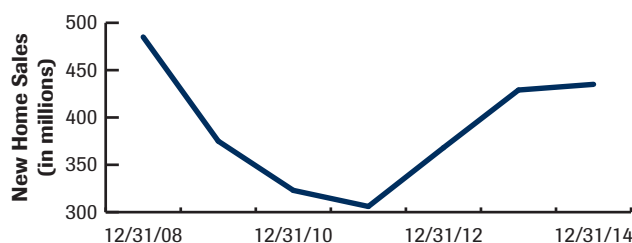
Is this housing's year?

Housing remains an enigma in this current expansion. Prices continue to rise though the increases have moderated, housing starts had their best year in seven with single-family activity—which has a much larger multiplier effect than multifamily—accelerating in the fourth quarter, and

builder sentiment is bouncing around last summer's eight-year high. But sales have been up one month, down another, as have starts and permits. The good news is that despite their choppy nature, both starts and permits have moved and stayed above the 1 million mark, double their half-century lows at the nadir of the housing crisis.

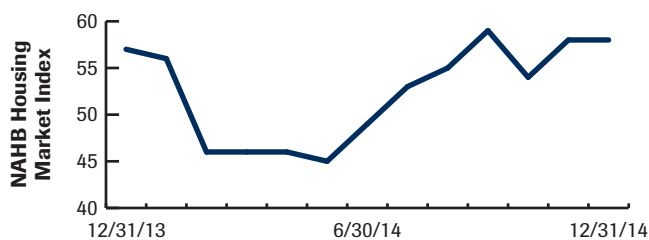
As we've said before, the big question overhanging housing is if and when will Millennials begin to enter the home-buying market? The one-two punch of student loan debt and a tough job market was a major deterrent the past several years, but a much-improved job market and another round of extremely low mortgage rates could be the catalysts to move them off the fence—mortgage applications surged in January. Then again, there are suggestions the younger generation may be just as happy renting as opposed to owning for years to come, a potential socio-demographic shift that would have significant implications for housing.

New Home Sales: 12/31/08-12/31/14



Source: Bloomberg, as of 12/31/14.

NAHB Housing Market Index: 12/31/13-12/31/14



Source: Bloomberg, as of 12/31/14.

When—not if—for the Fed

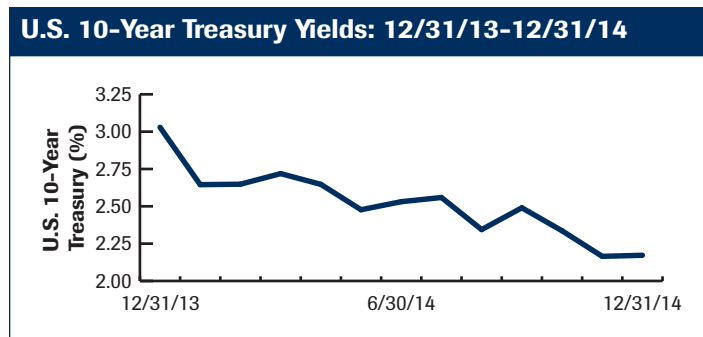
Even though the futures markets have been pushing back the possibility of an increase in the target funds rate this year, Fed policymakers—in both public comments and in their most recent public forecasts—continue to suggest they are wedded to a move, possibly as early as summer. This would mark a dramatic shift in Fed policy, all the more so given other central banks are moving in an opposite direction. The last time the Fed raised the target rate was a quarter-point hike in June 2006. It began methodically lowering the rate in the fall of 2007 amid concern about the economy and a housing credit crisis, accelerated the moves in 2008 and effectively dropped the target rate to zero by the end of 2008, where it's held since.

The debate over the timing of a Fed move has been complicated by mounting deflation worries in Europe, where the European Central Bank (ECB) just unveiled a quantitative easing (QE) program totaling more than 1 trillion euro (\$1.16 trillion) to spur growth and inflation, and by oil's nearly 60% plunge in price off summer's peak. The ECB move is likely to constrain yield movements in the U.S. while oil's collapse almost assuredly will drive headline U.S. inflation to near zero in coming months, undermining a key determinant of any Fed urgency toward rate normalization. As previously mentioned, stagnant wages also continue to act as an offset to an otherwise dramatically improving labor market. Still, if the Fed does go ahead and act this year as it seems determined to do, any increases in the target funds rate are expected to be mild.

The bottom line

The economy and markets entered 2015 under a cloud of uncertainties—over falling oil's impacts, potential European deflation, the timing and magnitude of Fed tightening, the strengthening dollar's drag on U.S. multinational firms, to name a few. But the fundamentals really have not changed all that much from the perspective of the equity investor: the U.S. economy is growing at an above-trend pace, earnings continue to surprise to the upside particularly versus cautious expectations, inflation remains well in check and interest rates appear wedded to stay near historical lows even if they do begin to move up this year. This is, as Federated equity strategists have said, a Goldilocks environment for stocks.

For bonds, the story isn't as positive but we believe there are areas of relative strength under this scenario, led by investment-grade and high-yield credit and commercial MBS, all of which are overweight in our overall underweight fixed-income allocations in our stock-bond model. We continue to put Treasuries at a severe underweight. We recognize that they surprised last year but find it difficult to believe they will do so again in 2015.



Source: Bloomberg, as of 12/31/14.

Views are as of 1/27/15 and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

High-yield, lower-rated securities generally entail greater market, credit/default and liquidity risks, and may be more volatile than investment grade securities. Investments are subject to risks and fluctuate in value.

The value of some mortgage-backed securities may be particularly sensitive to changes in prevailing interest rates, and although the securities are generally supported by some form of government or private insurance, there is no assurance that private guarantors or insurers will meet their obligations

While stocks offer the potential for greater returns than bonds, they tend to be more volatile.

Bond prices are sensitive to changes in interest rates, and a rise in interest rates can cause a decline in their prices.