SAWGRASS Asset Management, L.L.C.

Financial Review & Outlook

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Stock Market: Quarter in Review

- The equity markets posted another solid quarterly gain to register their best first six month start since 1998 and their first double digit percentage first half since the very strong year of 2003.
- Stocks continued their winning ways through the early part of the quarter but endured the deepest retracement of the year as news of the potential tapering of the Federal Reserve's quantitative easing programs started a sell off that saw the markets give back all of their earlier progress. Equities then stabilized and rallied sharply in the last week of June to post decent gains but off previous highs.
- The cyclical and higher beta sectors were generally rewarded during the quarter after lagging defensive and stable growth companies during the first quarter rally.
- Volatility and correlations continued to increase from their recent lows set during the first quarter for volatility and the fourth quarter of 2012 for correlations after both having enjoyed a relatively steady descent from multi-year highs.
- Value and small cap outperformed growth and large cap as the best performing sectors were consumer discretionary, financials, and healthcare while the relative laggards were materials, energy, and utilities.

Stock Market: The Quarter Ahead

- Stocks enter the second half with an impressive year to date gain having avoided a ten plus percent correction since March of last year. However, despite eventual annual gains, each of the strong starts over the past three years has been completely retraced at some point in the ensuing months.
- The large cap indices are currently in the process of retesting their breakouts to all-time highs that have pushed them outside the very large range that has contained prices since the peaks in 2000. This retest has been successful so far and has helped improve investor sentiment toward the longer term potential of the equity markets.
- The recent performance of some of the more cyclically oriented sectors (consumer discretionary, industrials, financials) and the lack of relative weakness in small and mid-cap stocks offers hope for further strength going forward.
- However, the disconnect between equity market performance and underlying economic strength and its eventual effect on earnings growth has reached notable levels leaving stocks vulnerable to a more significant retracement if expectations built into current valuations are not met.
- Additionally, the recent turmoil in interest rate and select commodity markets along with the spike from a six year low in the S&P 500 Volatility Index has decreased the relative stability the markets have enjoyed so far this year and may be signaling more challenging conditions ahead.

2nd Quarter Scorecard *Table 1*

Index	Quarter	YTD	1 Year
S&P 500	2.9%	13.8%	20.6%
Russell 1000	2.7%	13.9%	21.2%
Russell 2000	3.1%	15.9%	24.2%
Russell 3000	2.7%	14.1%	21.5%
Russell 3000 Growth	2.2%	12.2%	17.6%
Russell 3000 Value	3.1%	15.8%	25.3%
Barclays Capital US Aggregate	-2.3%	-2.5%	-0.7%
3 Month T-Bills	0.02%	0.04%	0.11%

Source: Bloomberg & Russell Investments

- The Federal Reserve's continued support through quantitative easing has helped the markets fend off challenging news from the domestic and global economy over the past four plus years. However, the recent signaling of a reduced rate of easing caused a sharp reaction in global markets and has left questions about the longer term effects of this change in policy at the forefront of investor attention.

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Interest Rate Summary ***Table 2***

	6/30/12	3/31/13	6/30/13	Qtr Change	12-Month Change
3 Month T-Bills	0.1	0.1	0.1	—	—
5 Year Treasury	0.7	0.8	1.4	+0.6	+0.7
10 Year Treasury	1.7	1.9	2.5	+0.6	+0.8
30 Year Treasury	2.8	3.1	3.5	+0.4	+0.7
5 Year Corporate ('A')	2.0	1.7	2.3	+0.6	+0.3
10 Year Corporate ('A')	3.2	3.1	3.8	+0.7	+0.6
30 Year Fixed Rate Mortg.	3.7	3.7	4.4	+0.7	+0.7

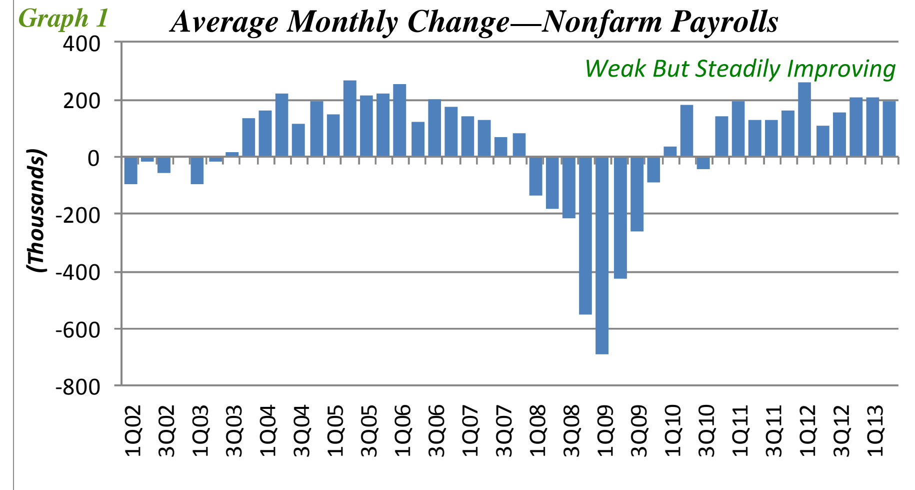
Source: Bloomberg

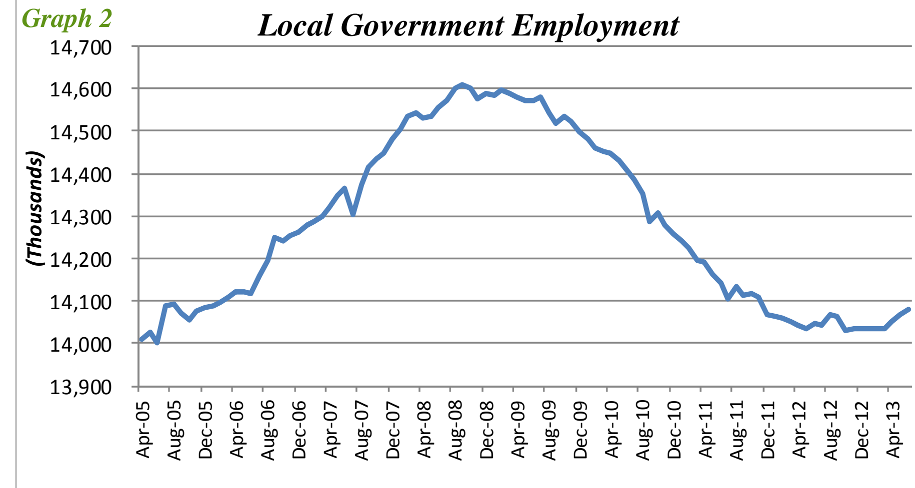
The Economy: Plodding Along

The economic expansion has now entered its fifth year but remains more of a recovery than expansion. GDP growth (year-over-year) turned positive in early 2010 but is mired in a subnormal range of 1 ½ - 2 ½ percent. Since the trough in February 2010, non-farm payroll employment has grown by approximately 6.5 million jobs. During the two years prior to that, over 8.7 million jobs were lost. Thus far, the labor market has recovered approximately 75 percent of its jobs lost and at its present pace will have recovered all the jobs lost by the middle of 2014. Monthly jobs growth during the most recent quarter has remained modest and slightly below the monthly gains of the prior two quarters. Moreover, this is barely what is believed to be required for significant improvements in the unemployment rate (see Graph #1). This is evidenced by the meager 0.2 percent drop in the unemployment rate during the first half of 2013. Local government employment appears to have finally stopped falling in late 2012 and has stabilized some 4 percent below its 2008 peak (see Graph #2).

During the past year, housing has been lifted by a near perfect combination of low mortgage rates, low prices and more recently, lower inventories. At current sales rates, the inventory of existing homes has been approximately 5 months. This is less than half the 12 month inventory that existed only three years ago and is less than the long term average of 6-7 months. While home prices have clearly begun to firm and are up some 14 percent from their lows of early 2012, prices, on average, remain approximately 24 percent below their previous peak reached in mid-2007 (see Graph #3).

Economic conditions, on balance, have clearly improved. While growth is likely to continue during the months ahead, the path is expected to be uneven and remain at a disappointingly slow pace.





The Fed & Interest Rates: QE's RIP? Not Yet

Financial markets have been recently obsessed with the prospect and timing of the Federal Reserve's plans to reduce support for the economy by phasing out its bond purchase program and eventually allowing interest rates to move back to "normal" levels. As a result, interest rates have moved higher during the past month with rates across most maturities having increased by approximately 0.5 percent during the quarter. From their lows of July 2012, long term Treasury Bond yields are higher by a full percent (see Table #2 for quarter and year ago comparisons). Since December 2008, with the lowering of the target Fed Funds rate to essentially zero, the Federal Reserve has been "all in" with its most significant and prolonged policy stimulus ever. As economic growth gains traction, some pull back from this posture is to be expected. The absence of any inflation pressures coupled with weaker than normal recovery gives the Fed the luxury of delaying any such action until employment conditions improve further (generally believed to be indicated by an unemployment rated below 7 percent). *While our long term expectation for higher rates remains intact, in the near term, we expect rates to remain roughly in line with current levels.*