Equity Markets Reach Record Highs as U.S. Recovery Broadens; Loose Fiscal, Tight Monetary Policies Working in Washington; Eurozone Financial and North Korean Geopolitical Risks Boost Volatility; Plus Our Latest Fixed-Income Strategy Evolution

Stocks rallied to record highs in the first quarter in a display of renewed confidence by investors, businesses and consumers. In the first three months of 2013, Indices that measure the broad stock market reached the highest levels since 2007 with gains across a broad range of industry sectors and asset classes. The U.S. 10-Year Treasury yield, which started the quarter at 1.75%, reached as high as 2.06% before ending the quarter at 1.85%.

Economic recoveries typically don't happen in a straight line, but the underlying improvement and momentum in the U.S. that started in the interest sensitive housing and auto sectors are broadening. Moderate but persistent employment gains, an expanding manufacturing sector and increases in consumer spending are all contributing. The manufacturing sector registered its fourth consecutive month of expansion in March. The underlying exports and employment areas within manufacturing were particularly strong. In February, consumer spending rose the most in five-months as the so-called wealth effect (a tailwind from rising home and stock prices) and higher expectations are offsetting the impacts from the payroll tax increase. U.S. consumers have largely repaired their household balance sheets in the wake of the housing crash and recession and are once again increasing borrowing.

The gains in spending follow other signs of an economy gathering momentum. Hiring is up, businesses are spending more, and the housing market is recovering, all as the stock market is hitting record levels. In the U.S., real GDP expanded at a rate of 1.8% in 2011, a 2.2% pace in 2012, and economic forecasts, which are currently rising, show growth could modestly improve on a year-over-year basis in 2013.

Europe, which seemed to have made progress over the past six months, took several steps backward in the first quarter in the form of the "bail-in" in Cyprus and political deadlock in Italy, reawakening crisis fears. In Cyprus, Eurozone regulators worked to negotiate through another crisis; however, the costs were high. In a Groundhog Day type repetitive fashion, European banking crises appear to be never ending and in our view the regulators need to do much more than just put out the fires by rapidly moving forward with tighter banking integration and regulation. Cyprus is a tiny island nation which accounts for only 0.2% of Eurozone GDP, but contagion fears raised volatility as depositors were tapped for a portion of the rescue of two of its largest banks, setting a potentially dangerous precedent for the continent's fragile banking system.

After indecisive elections earlier this year, Italian politicians have not been able to form a government, placing any additional fiscal reforms in jeopardy. An "institutional" government could be formed in the near-term, or the current government could remain in place until new elections take place in the Fall. We will be closely monitoring the situation for signs of political wildcards that could rattle financial markets and for a potential end to the stalemate. Overall, systematic risk from Europe will continue to be a drag on the global recovery in 2013. Household and banking sector deleveraging, as well as a banking resolution will be critical.

Harsh rhetoric and actions out of North Korea raised geopolitical concerns in early April. In response to joint military exercises the U.S. conducted with South Korea, North Korea restricted access to a joint industrial zone, moved a missile to its eastern coast and authorized use of nuclear weapons for "self-defense." U.S. Defense Secretary Hagel said that Kim Jong Un's regime presents, "a real and clear danger" that presents a threat to the interests of our allies, including South Korea and Japan. The U.S. is also preparing to deploy an advanced missile defense system to Guam given the heightened tensions. We will be closely monitoring this situation.

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Back in the U.S., the combination of loose fiscal and tight monetary policies from central bankers and legislators in Washington appears to be working. Inflation remains muted, and below the Federal Reserve's threshold target of two percent, allowing the central bank to remain extremely accommodative with its third asset purchase program (QE3) and a continuation of the near-zero Fed funds target rate policy.

The fiscal policy story is also an improving one. While restraint is not typically pretty, progress is being made and deficits are coming down. In a potential return to regular legislative order, as compared to stopgap measures and continuing resolutions, budgets have been passed in both chambers of Congress (even though it is highly unlikely that the House and Senate will agree on a budget compromise). Despite the positive near-term fiscal improvement, the long-term debt trajectory appears unsustainable and will require reform to entitlements. We will be watching for any progress on this front. The impacts from the across the board reductions in spending levels known as sequestration will be a drag on U.S. economic growth; however it will take some time for the measures to have an impact.

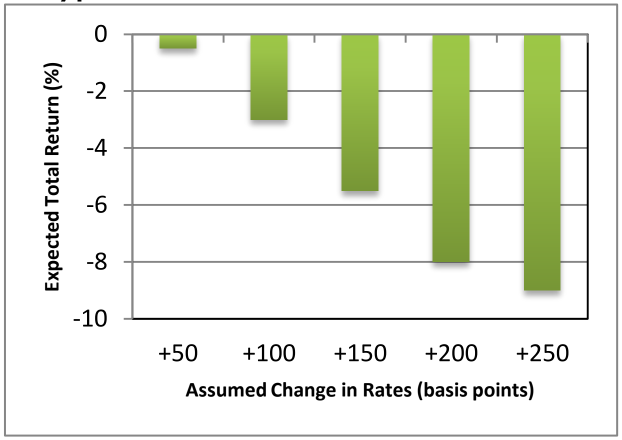
While the pace of future gains will likely moderate from year-to-date levels, given the favorable policy backdrop and improving economic fundamentals, we remain constructive on equities. However a pullback could happen at any time as the market has not experienced a five percent decline since mid-November following the presidential election. While we would always reassess fundamentals and valuations at such a time, our inclination is that we would use any such opportunity to selectively add to high-quality equities. Overall, companies continue to do equity friendly things like boost dividends and repurchase shares, and undertake bond holder friendly measures such as maintain large cash balances and high levels of cash flow.

Switching to fixed-income, given the historically low levels of both policy and market interest rates, combined with an improving economy and a Fed that could start to reign in its asset purchase accommodation program at some unknown future date, our investment approach is evolving. Importantly, the goals and objectives remain the same. Those are to provide a steady source of cash flow and to protect principal values. The investment vehicles and strategy however are rotating in order to try and best meet these goals and offset what we view as the largest risk in fixed income markets - duration risk.

Since the early 1980s, interest rates have been in a secular decline. Over this time period, our primary focus in fixed-income was managing credit risk. While this is still important, given the expansion in the economy and the improvement in corporate balance sheets, income statements and cash flow levels, we are comfortable accepting more in the way of credit exposure in order to limit the potential damaging impacts of duration. Duration measures the sensitivity of bond prices to interest rates. Duration increases with maturity. Rising rates put principal values at a risk of loss, and the longer the duration, the greater the risk. The potential damage, in the form of capital erosion of long-duration bonds, could be significant. Reducing duration can help mitigate interest rate risk in a rising rate environment.

With interest rates at historically low levels, building an investment grade, fixed income ladder with individual U.S. Treasuries, Agency notes and investment grade corporate bonds, with yields above the rate of inflation became impossible. Our new allocations include a core exposure in investment grade credits as well as GNMAs, with additional representation in the multi-sector bond and bank loans asset classes. The multi-sector bond strategy allows for a flexible approach in search of attractive, risk managed opportunities and bank loans offer attractive, real-yields and can help protect against the effects of rising rates. Importantly, we are not attempting to reach for yield with this strategy evolution, but rather maintain a steady source of income and protect principal values. By reducing duration risk while accepting a carefully allocated level of credit risk, we believe we can add value in an improving economy with a flat to rising interest rate environment, as rates normalize over the next several years.

Bond Prices Fall When Rates Rise, Hypothetical Interest Rate Scenarios



Source: Eaton Vance as of June 30, 2013. Assumes instantaneous rise in interest rates and adjustments to Barclays U.S. Aggregate Index.