Economic & Market Review

~ First Quarter Investment Newsletter ~

Steven W. Lieberman, MBA, CFP® Summit Financial Resources, Inc. (973) 285-3637 slieberman@sfr1.com

Executive Summary

It is said the investment markets climb the wall of worry and slide down the slope of hope. The first quarter provided no shortage of footholds for an ascent.

True to the adage, the capital markets turned in respectable results. All major asset classes, domestic and international, delivered positive results for the quarter. Domestic equities and REITs performed the best followed by commodities and high yield fixed income. Lower risk fixed income categories brought up the rear with slight gains.

A cursory review of final capital market returns for the period does little justice to the volatility, moving parts, and uncertainty that culminated in said results. Rising commodity prices, Mid East conflagrations, European sovereign debt issues, Japan's natural disasters, and mounting global inflation were all meaningful, impactful, and front and center during the quarter.

As the second quarter gets underway, many uncertainties remain. The collective wisdom on the fallout from Japan's events suggests near-term economic weakness will be followed by recovery-induced economic acceleration in the second half of the year. While this remains to be seen, $200 – 300 billion of estimated damage to a $5.4 trillion economy could certainly prompt rebuilding. Meanwhile, Japan's importance to the global supply chain, particularly in electronics and autos, is starting to be appreciated as parts shortages and production shutdowns mount.

Rapid emerging market growth and related improvements in living standards have put pressure on infrastructure and natural resources. Inflation has become a global problem and tensions in the Mid East have only turned up the heat. Oil closed out the quarter at a two and a half year high leaving U.S. consumers to spend nearly $150 million more per day on gasoline.

European leadership is engaged in fighting a multi-front war. Fiscal and financial troubles continue with bank stress tests underway and Portugal only days away from a financial bailout. Investor attention is increasingly focused on Spain. The bailout mechanism to be used for Portugal, already in action in Greece and Ireland, is being revamped to expand its capacity. To add to investor confusion and uncertainty, policymakers will eliminate this bailout program entirely in 2013 in favor of a new structure. Lastly, in an unfortunate confluence of events, inflationary pressures have forced the European Central Bank to implement monetary restraint. The Bank of England will follow suit shortly.

Closer to home, Congressional debate rages on how aggressively deficit reduction should be sought. The pawns in this chess match are the U.S. government's budget and the U.S. federal debt ceiling. The first issue is noise while the second has meaningful long-term implications. While the fiscal side of the government does their good work, the Federal Reserve has monetary related decisions to make as well. QE2 comes to completion in June with investors wondering what is next and what it all means for the markets.

As discussed in greater detail in the following pages, the U.S. consumer has effectively balanced the challenges of unemployment, high debt levels, and weak housing while serving as a key engine of economic growth. GDP rose modestly in the final quarter of 2010 with growth expected to moderate a bit in the first quarter of 2011. Labor markets have improved, housing is not quite as weak as it seems, and the manufacturing and service sectors continue to point toward economic expansion.

Economic Review and Outlook

Economic Growth

Gross domestic product (GDP) in the U.S. grew 3.1% in the final quarter of 2010. Economic output of $14.9 trillion was 2.8% higher than last year, in real terms, and eclipsed the previous all-time peak.

Data Source: U.S. Department of Commerce

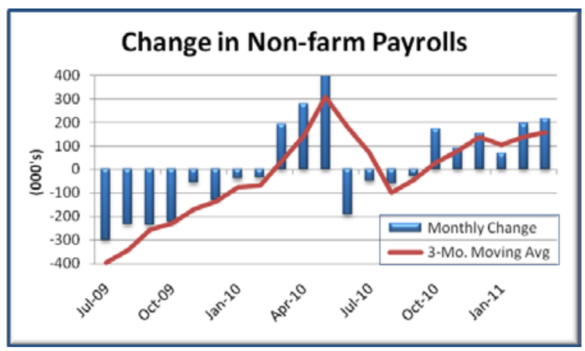
Personal consumption expenditures accelerated throughout the year. Net exports migrated from a large drag in the second quarter to the most significant positive contributor to growth in the fourth. Offsetting the favorable reversal in net exports was a comparable deterioration in inventory adjustment. As we have mentioned in the past, growth boosts from inventory are unsustainable and thus temporary. Fortunately, other elements of the economy picked up the slack to enable continuation of positive growth.

As the year began, expectations for first quarter GDP growth centered around 3.5%. Mid East tensions and rising commodity prices, particularly gasoline, tempered the outlook to something closer to 2.5%. In similar manner, expectations for second quarter growth have been dialed back to about 3.5%. For the full year, consensus expectations call for 3% growth.

Among many, there are two key moving targets that are hard to estimate but will influence growth in 2011 and beyond. The first is crude oil. The World Bank estimates the current level of crude, if sustained, would shave 0.4% off of world GDP growth in 2011. The second is the impact of full depreciation [in the U.S.] on capital expenditure budgets. The possibility exists that 2012 spending will be pulled forward into 2011. At the upper end of estimates, some believe as much as 2% of 2012 GDP will be effectively pulled into 2011 as a result of this tax policy.

Employment

The jobs market has made progress over the past several months. Payroll additions have averaged 159,000 per month this year and 1.3 million more people were employed at the end of March than the comparable point last year. The number of unemployed people stands at 13.5 million, down over 2 million from the peak. Depicted below, the trend in payroll expansion has been favorable since the official date of economic recovery.



Data Source: U.S. Department of Labor

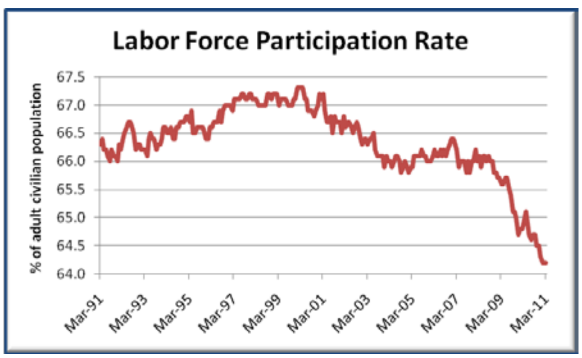
Jobless claims, both initial and continuing, began a downward trend in the fall which continued throughout the first quarter of this year. Unemployment, now at 8.8%, dropped impressively from 9.8% last November. Workforce underutilization, the so-called U-6 metric, is down to 15.7% from a high of 17.4%. Importantly, this gauge is below 25 million people for the first time in almost two years.

The economy had been in the throes of recovery for well over a year with little commensurate reaction in the labor market.

This was highly atypical for an economic expansion, particularly one following a pullback of such magnitude. As a result, favorable developments of late are welcomed.

Much work remains and the numbers discussed above show improvement, but are definitely not healthy. Payroll growth needs to be much higher to meaningfully chip away at unemployment rosters. Initial jobless claims, while improved, still reflect weakness. An additional unsettling dynamic posing risk to economic growth is the number of people that have left the workforce entirely.

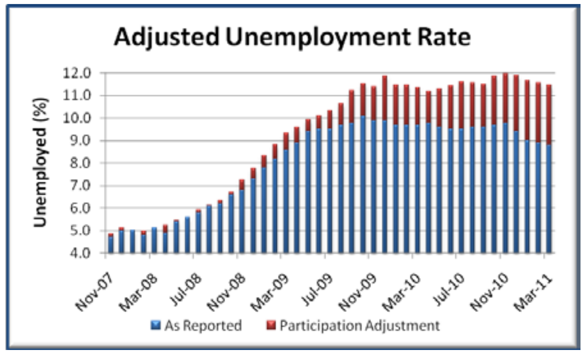
Long-term economic growth is a basic function of labor force growth and the productivity of that force. Anything that impacts either factor, positively or negatively, impacts growth. The following graph shows the percentage of the adult population engaged in the labor force.



Data Source: U.S. Department of Labor

The trend is not favorable. Furthermore, people that leave the labor force are not factored into the majority of labor market statistics. They simply no longer count….in the stats anyway.

To achieve an alternative view of the labor market, we reran the government's reported statistics while holding the participation rate constant at prerecession levels. The effective unemployment rate is illustrated in the following graph.



Data Source: U.S. Department of Labor

The blue bars represent what the government has reported as the unemployment rate. The red bars add back the people that have left the labor force, presumably due to a dearth of opportunities.

Rather than peaking at 10.1% (as reported) and falling to a current level of 8.8%, this analysis shows unemployment peaked at something closer to 12.0% and has fallen less substantially to 11.4%. The total number of unemployed is closer to 18.1 million versus reported 13.5 million.

The labor market has indeed improved. However, the degree of improvement and the current level of health are not quite as robust as some reported numbers would suggest.

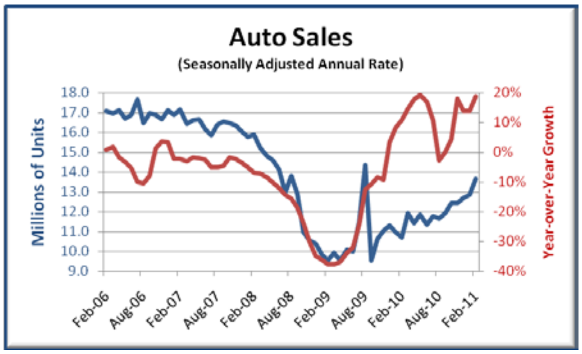
The Consumer

The financial health of the consumer continues to improve. The personal savings rate, after bottoming in Q3 2005, is now more in-line with long-term historical averages.

Data Source: U.S. Department of Commerce

Household debt has trended down for the past ten quarters, falling to 84% of GDP from a peak of 92%. Saving more, paying down [or walking away from] debt, and strong capital market gains have driven the consumer's net worth up $8 trillion from the bottom. This is the midpoint of recovery, $8 trillion to go.

The consumer continues to spend. Through February, retail sales have shown positive year-over-year growth for 16 months in a row. Even the beleaguered auto industry has shown signs of life by stringing together two years of steadily rising sales. February's 13.7 million annualized rate of vehicles sold was an increase of over 40% from the depths of the recession.



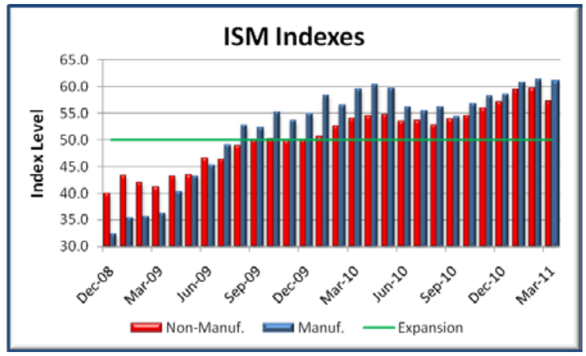
Data Source: U.S. Department of Commerce

The rate of annual volume growth, shown in red above, has been accelerating lately with year-over-year percentage gains averaging in the high teens since November.

The consumer has navigated challenges in the housing and labor markets reasonably well. The new curveball, of course, is higher gasoline prices. By quarter end, gasoline had increased by an average of 37 cents per gallon. This equates to a whopping $143 million additional dollars being pumped into American gas tanks each day. It is little wonder why each of the major consumer confidence indexes deteriorated markedly following the spike in fuel costs.

Manufacturing and Service

After slowing somewhat last summer, growth in both manufacturing and service accelerated into year-end 2010.

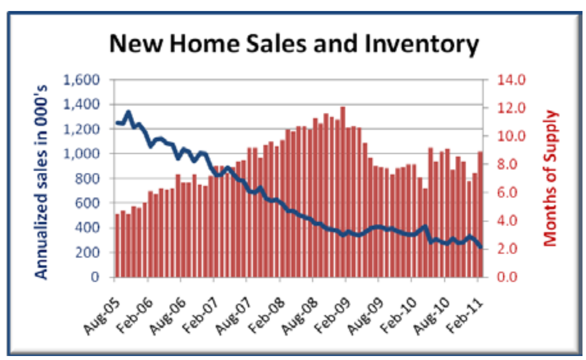


Data Source: Institute for Supply Management

As shown, increased global challenges this year have caused ISM readings to level off in manufacturing and decline modestly in the service sector.

Real Estate

The housing market continues to face headwinds. Government attempts to spur activity, support prices, and assist troubled homeowners have had limited success. New home sales, shown by the blue line in the following graph, hit a new low in February. The rate shown, 250,000 units on an annualized basis, is a mere one-fifth of the industry's operating level for much of the previous decade.

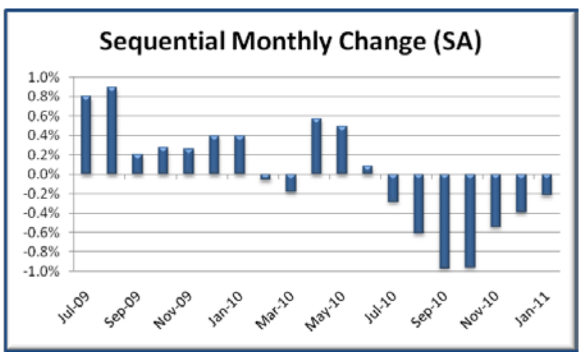


Data Source: U.S. Census Bureau

Also shown in the graph above (red bars) are the months of inventory available for sale at the current pace of sales. The story here is more positive as this metric is closer to a healthy level of six months, and the trend has generally been down over the past year.

The previous figure and commentary have both positive and negative implications for the future. Low volumes are negative for employment, the construction industry, and overall economic output. Normalized inventory levels, on the other hand, help mitigate pricing pressure and should be supportive to real estate values.

Current fundamentals of the housing market have led many to declare a double dip housing recession is either here now or on the horizon. The Case-Shiller home price index, which looks at transactions of existing homes, is back down to its recession low. Year-over-year price declines have resumed in recent months and the data shows consistent sequential monthly price declines since last July (shown below).



Data Source: S&P/Case-Shiller

We would caution, however, that in investing as well as economics, the absolute level and/or rate of change can be far less critical than a <u>change</u> in rate. This second derivative phenomenon is often the best way to anticipate favorable, or unfavorable, fundamental developments before they present themselves in core data.

When it comes to second derivative changes, the existing housing market is showing a decreased rate of decline. The previous graph is one example. While sequential price declines continue, the rate of decline has slowed materially. Furthermore, the Case-Shiller index is both two months delayed AND based on a three-month moving average. The first makes the data stale and the second dampens its response rate. Our read of this suggests the housing market, in real-time, may not be as weak as face value numbers suggest.

The number of markets showing sequential price gains is another favorable and confirming data point to our thesis. Last summer, none of the 20 market segments tracked by Case-Shiller reported sequential price gains. By January, eight of the 20 were gaining each month. This additional second derivative view illustrates a stabilizing, not degrading, market.

A discussion of real estate would not be complete without at least a brief mention of the commercial real estate space. This market continues to have challenges that include vacancy rates at or near historical highs. That being said, some flickers of hope have emerged. During the fourth quarter, occupied office space increased for the first time in three years while average office rents ticked higher for the first time since the second quarter of 2008.

Inflation

Inflation concerns have mounted globally with central banks increasingly focused on this nemesis. What started as an emerging market issue has gravitated to developed economies as well. In recent days, the European Central Bank joined developing countries such as China, Korea, India, and Brazil in implementing tightened monetary policies. The Bank of England has telegraphed the notion that it too would join the crowd in the near future as inflationary pressures in England have become particularly acute.

Meanwhile, the party line out of the Federal Reserve is that U.S. inflation is contained and expectations are appropriately anchored. In validation of this claim, year-over-year consumer price inflation (total and excluding food and energy) remains at a multi-decade low. Additionally, the TIPS market shows no increase in inflation expectations compared to what they were at this time last year.

That being said, minutes from the last Fed meeting documented a debate on rising inflationary pressures and the potential need for action. Recently, various Fed governors have made fairly hawkish statements on inflation at public appearances. The futures market has dialed in a 30% chance of a rate increase by year-end with some pointing to next February as likely timing. While various market pundits have suggested the Fed may not complete its latest monetary experiment, QE2, we see little chance of the program's early termination.

Governments, Politicians & World Events

There is no shortage of ongoing issues that will be meaningful to the domestic and world economies as well as the capital markets of the same. While any of the following topics could be the subject of a stand-alone research piece, the intent is to provide a brief review of the moving parts across the globe. These include:

- The fallout from the natural disasters and nuclear crisis in Japan is uncertain. It is widely expected that Japanese GDP will slow in the near-term and accelerate in the second half of 2011 on the rebuilding effort.
- Ongoing tensions in the Mid East and North Africa pose uncertainty for millions of people, the global economy, and the energy markets. The intensity, duration, and cost of related military action in Libya is unknown and troubling.
- Inflationary pressures have many countries intensely focused on monetary restraint. Global growth will slow as a result and the potential for policy errors is heightened.
- Fiscal austerity in the U.S. and Europe will dampen growth and may stall nascent recoveries. As it relates to Europe, combined fiscal and monetary restraint in the face of economic weakness in peripheral countries seems ripe for disaster.
- Modification to the euro-zone's EFSF (the current but temporary bailout mechanism) is up in the air. Leaders have agreed that the effective lending capacity should be expanded, but have tabled discussion on how to affect the change.
- Squabbling over the launch, funding, and structure of Europe's permanent financial stability program (ESM) leaves the investment community, particularly bond holders, with questions. This financial support tool is slated to start in 2013.
- The second round of European bank stress tests is scheduled to be reported in June. Political pressure and corresponding regulator [and leadership] weakness all but assure the results will be as unreliable and unhelpful as those from last year.
- The Federal Reserve is scheduled to complete its latest purchase of $600 billion in Treasury securities by the end of June. Early termination, extension, and/or additional program(s) are all potential outcomes. Our expectation is the program will complete as scheduled but no further initiatives will take its place.
- Portugal is days away from what will be a bailout estimated in the range of €50 – 75 billion. Attention has already turned to Spain as the next likely bailout candidate.
- The U.S. Government has two critical financial issues coming to a head. The first is agreement on the federal budget and the second is an increase in the nation's debt ceiling. Political posturing related to both poses the possibility of disruptions. Budget related disruptions will likely be short-term with no lasting impact. Failure to raise the debt ceiling, however, has massive and long-lasting economic implications.

Capital Markets Review and Outlook

Overview

All major asset classes, domestic and international, delivered positive returns for the quarter. Domestic risk assets (equities, REITs, & high yield fixed income) performed the best.

Capital Market Returns

	1st Qtr 2011
U.S. Treasury Bills	0.1%
Barclays Aggregate Bond	0.4%
Barclays Municipal Bond	0.5%
S & P 500	5.9%
Dow Industrials	7.1%
MSCI EAFE (Int'l Equities)	3.4%
DJ UBS Commodity Index	4.4%

Data Source: Morningstar

News flow and economic developments during the period were intense at times which led to substantial swings in asset prices. A review of the VIX over the past quarter illustrates the intra-period turbulence.

Data Source: Yahoo! Finance

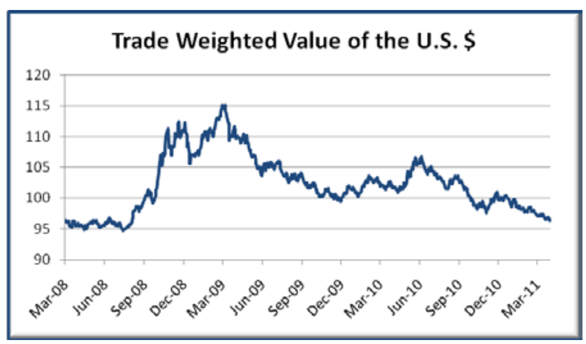
Of note, the severity of the seven day drop following the March 16 peak was historically unprecedented with the index falling 28%.

U.S. corporate profits rose last year at the fastest pace in six decades with analysts expecting more of the same this year. S&P 500 earnings growth is expected to come in at 13% for both the first and second quarters with the full year expected to increase by 15%.

Although expectations are favorable, it should be noted that corporate profit margins are well above the average for the past 15 years. On that point, Standard & Poor's expects peak earnings this quarter with challenges following. The organization's main fundamental concern is unemployment and slow wage growth leading to sluggish demand. They also point to tougher year-over-year comparisons as the year unfolds. We would add that commodity costs have risen, capital expenditures are on the rise, and companies are starting to hire. These factors tend to compress margins.

Equity Markets

Domestic equity markets rallied during the quarter with the S&P 500 rising 5.9%. International equity markets rose as well with developed and emerging markets up 3.4% and 2.0%, respectively. U.S. dollar weakness drove much of the international equity gains. As shown below, the dollar is back to its pre-financial crisis level.



Data Source: U.S. Federal Reserve

Fixed Income Markets

Bonds underperformed stocks for the quarter but finished in positive territory. The Barclays Aggregate was up 0.4%, municipals gained 0.5%, and TIPS returned 2.1% for the period. High yield corporate bonds were the asset class leader, rising 3.9%. The 10-year Treasury started the quarter with a yield of 3.30% and finished yielding 3.47%. Between start and finish, however, the yield was as low as 3.22% and as high as 3.75%.

The investment opportunity in corporate bonds has diminished:

- Investment grade spreads have fallen from a peak of 5.5% back to a pre-crisis level of 1.2%. There is little room for further improvement.
- Central banks across the globe are either winding down monetary easing or have begun tightening cycles.
- Companies are being pressured to spend. M&A is up and stock buybacks more than doubled in 2010 versus the prior year.

These are not creditor friendly developments.

Hedge Funds and Alternatives

REITs were up 7.2% for the quarter, the best performing asset class for the quarter. Commodities performed nearly as well, rising by 4.4%.

The HFRI index of fund of funds hedge funds rose 0.8% for the quarter. Fixed income and event-driven hedge funds performed the best while macro and short-biased strategies underperformed.