Economic & Market Review

~ First Quarter 2012 Investment Newsletter ~

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Executive Summary

Stock market returns during the first quarter of 2012 were exceptional. The S&P 500 index gained 12.6%, the MSCI EAFE index was up 10.9%, and MSCI Emerging Markets index rose 14.1%. The S&P 500 is back to a pre-crisis level last seen in May 2008 and the NASDAQ Composite, now over 3,000, has not been at this price level since December of 2000.

The credit side of the bond markets performed admirably as well. High yield bonds gained 5.3% and investment grade corporate bonds rose 2.1%. Despite the strong credit rally, which kicked off on October 5 of last year, high yield spreads are now only back to their 15 year average.

The rally's roots were primarily grounded in the elimination, or perhaps delay, of acute European risks. The European Central Bank's two-stage infusion of over €1 trillion in funding to European banks acted to support the region's financial system and stabilize sovereign debt markets. Greece's successful debt restructuring and receipt of a second round of bailout financing, to the tune of €130 billion, were also critical factors.

Another positive theme for the period was an improvement in economic fundamentals, most notably in the U.S. The domestic labor market has improved, manufacturing ticked higher, and the service sector accelerated. Consumer confidence rose and evidenced itself through exceedingly strong auto sales. Federal Reserve stress tests of the 19 largest U.S. financial institutions came in better than expectations as well. Even the finances of state governments have improved. Only four states have reported mid-year budget gaps this year compared to 15 last year and 36 the year prior.

As is typical, there were notable exceptions to the headline grabbing investment gains for the period. Decreased risk, improved economic growth, and a more sanguine Federal Reserve posed a challenge to U.S. government debt. Yields on 10-year and 30-year Treasuries each rose by 36 basis points, or 0.36%. As a result, government bonds lost 1.1% for the period and the government-heavy Barclays Aggregate Bond index barely edged a positive return, up 0.3%. Commodities were also challenged after China lowered its growth target for the first time since 2005. Should China's growth come in at its revised 7.5% target this year, it would be the country's slowest rate of growth in 22 years.

By quarter end, many investors were jolted by a case of "be careful what you wish for." Specifically, the Federal Reserve acknowledged a firmer economic footing and moved to a more hands-off approach. In short, baring significant retracement of economic progress, a third round of quantitative easing is not in the cards and Operation Twist will conclude as scheduled at the end of June. On this news, stocks were weak, interest rates rose, the dollar rallied and gold sold off.

As previously mentioned, Europe appears to have avoided catastrophe through deft ECB actions, a second round of Greek financing, and a reasonably well orchestrated restructuring of Greek debt. The avoidance of imminent disaster, however, should not be construed as a resumption of health. Many European nations are being strangled by austerity and the region, currently in recession, lacks a clear path to economic growth. Overall unemployment is at a 15-year high of 10.8% and will likely rise. Manufacturing is in a steep decline. Inflationary pressures have also increased unexpectedly, which ties the hands of the ECB. Country specific challenges abound:

- France lost its AAA rating in January which led to the immediate downgrade of Europe's temporary bailout facility (the EFSF).
- After reporting a 2011 deficit of 8%, Spain announced a new

series of austerity measures. The nation's resulting budget, the most stringent in over 40 years, will be a particularly bitter pill to swallow for a country with 23.6% unemployment. That is the highest rate for any major industrialized country and a euro-zone record! Meanwhile, Spanish government bond rates have spiked and a bond auction following quarter-end failed to raise desired funds and came off at higher yields than planned. The event causes concern that Spain may not be able to issue enough debt to finance its budget shortfall this year.

- Greece, showing signs of continued erosion under the pressure of austerity, is embarking on its fifth year of recession. Unemployment is 21% and rising. Despite restructuring, the country's debt remains so high that newly issued Greek bonds are already trading at a massive discount. Furthermore, the prime minister suggested a third bailout may be necessary.
- Portugal's bond yields have spiked to the same level that Greek bonds reached when politicians started to insist that private creditors take losses.

Recognizing continuing challenges and a need to enhance financial firewalls, European leaders expanded the region's bailout mechanisms (the EFSF and the ESM) to €700 billion. While this was a step in the right direction, the amount was deemed insufficient by many, including the International Monetary Fund (IMF).

As we progress into the second quarter and the remainder of the year, the following issues will be important.

Oil

During the first quarter, oil (Brent crude) and gasoline prices rose 12% and 21%, respectively. While a successful Greek bailout and modest economic improvement were factors, the dominant driving force was tension with Iran. Supply issues are a very real risk, particularly considering an embargo of Iranian oil starting in July. Obama has declared confidence in remaining global oil supplies, Saudi Arabia has vowed to make up shortfalls, and high level discussions have taken place regarding the potential to tap strategic petroleum reserves. The jury is still out, however, and spikes in energy prices have been factors, if not outright causes, behind many past recessions.

Corporate Earnings

U.S. corporate profit growth, thus far a bastion of the post crisis recovery, will be challenged this year.

- Corporate profits as a percentage of gross domestic income are at the highest level since 1968 and 28% above the 50 year average.
- Profit margins reached a peak in 2011 with nine of 10 S&P 500 sectors showing margin compression in the year's final quarter.
- Aggregate Q4 2011 earnings missed expectations and 2012 corporate guidance was not encouraging.
- Negative earnings pre-announcements for the first quarter of 2012 are running high.

Elections

Election uncertainty prevails at a time when government policy decisions are critical. The complexion of our government and the leadership in place will impact near-term decisions on personal tax rates, spending cuts, unemployment benefits, and defense spending.

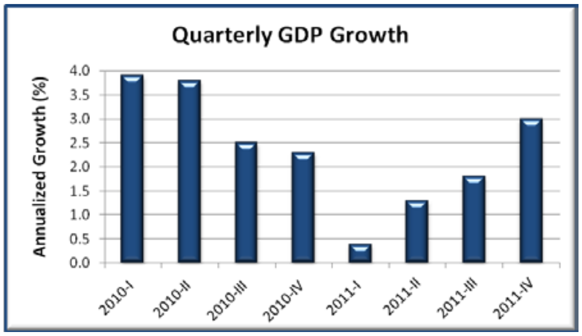
Fiscal Policy

Bernanke aptly describes year-end fiscal issues this year as a "fiscal cliff." Starting January 1, 2013, income taxes will revert back to pre-Bush levels, the payroll tax cut will go away, extended unemployment benefits will cease, and mandatory cuts to domestic spending will start. All told, these items add up to a staggering 3.5% of GDP. While many expect relief from at least some of the items on this list, it is doubtful that much progress will be made prior to elections. Furthermore, election results themselves will have a meaningful impact on eventual outcomes.

Economic Review and Outlook

Economic Growth

The government's final estimate for annualized U.S. GDP growth in the fourth quarter of 2011 was 3.0%. The result, driven by personal consumption and private investment spending, brought total 2011 growth to 1.7%.



Data Source: U.S. Department of Commerce

Consensus expectations for first quarter domestic growth are 2.0% with total 2012 growth expected to be the same.

Although U.S. growth looks to accelerate slightly this year, a major global theme is one of slower growth. After worldwide growth of 3.8% in 2011, the World Bank and IMF have forecast 2012 growth of 2.5% and 3.3%, respectively.

Contributing to the growth deceleration is an ongoing recession in Europe and a slowdown in China. China, for its part, lowered its target growth rate to 7.5%, the first decrease since 2005. Despite its slowing, however, China is still expected to generate one-third of total global growth this year.

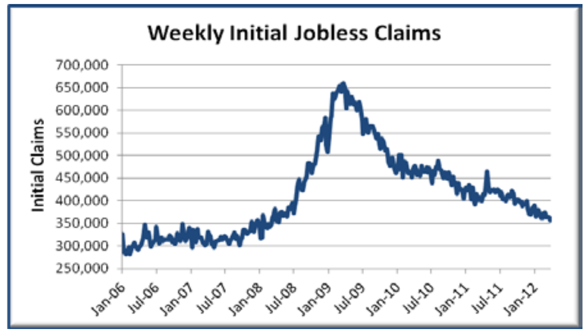
Employment

Much of the economic discussion in recent months has pointed to improvement in the labor market. Notwithstanding a disappointing payrolls report following quarter-end, domestic employment has indeed shown progress.

It is important to be mindful, however, that improvement is relative concept, not absolute. In absolute terms, the labor market remains very sick.

Consider the following labor market metrics:

- Jobless claims are at a four year low, yet 50,000 above the level of a healthy economy.



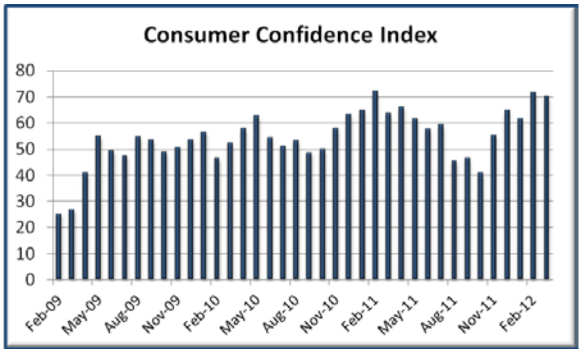
Data Source: U.S. Department of Labor

- Total unemployed workers are down 2.7 million from the peak, but there are 5.0 million more than at the start of 2008.
- The average length of unemployment has stabilized at 40 weeks, but this duration is more than double the long term average.
- The number of individuals counted as long-term unemployed is 1.4 million below the peak, but 3.9 million over the start of 2008.
- Monthly payroll growth averaged 158,000 over the past year, but the economy requires 125,000 each month simply to keep up with population growth.
- There are 3.7 unemployed individuals for every job opening. While this is a dramatic improvement from a peak of 6.7, it is still nearly double the historical average.
- Lastly, the unemployment rate of 8.2% is nicely below the crisis peak of 10.0%, but is aided materially by a disturbing drop in the labor force participation rate. Even with this obfuscating quirk in the metric, the unemployment rate is still above the 6% average of the past 20 years.

To sum up the labor market in medical parlance, the patient has left the intensive care unit, but is a long way from a hospital discharge.

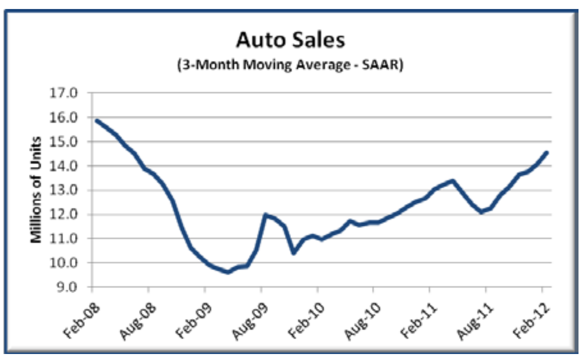
The Consumer

Consumer confidence has risen from last summer's lows and is zeroing in on a new post crisis high.



Data Source: The Conference Board

Spending has followed suit as retail sales in February were up 10.3% from the previous year and auto sales clocked in this past quarter near the fastest pace in four years.



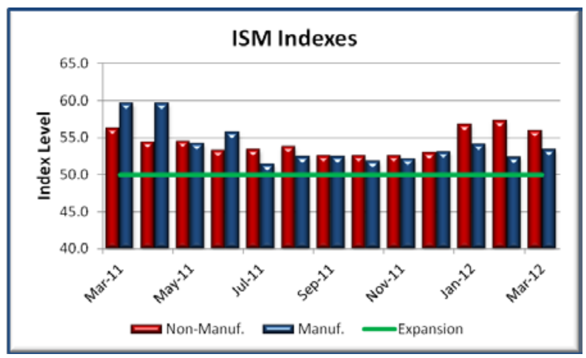
Data Source: U.S. Department of Commerce

Expectations are for vehicle sales in 2012 to reach a mid 14 million level compared to 12.8 million units last year.

In the year following the financial crisis, consumers found savings religion. Paying down debts and rebuilding balance sheets were clear priorities. The savings rate rose to levels more representative of the early 90s and not too far off from long-term averages. Over the past two years, however, the personal savings rate has trended down to a post crisis low of 3.7%. While low, this is not an unprecedented level. As a matter of fact, during the 10-year period ending in 2007, the savings rate averaged less than 2.9%. That being said, the ratio of household debt to GDP, at 80%, is double the average prior to 1980. Likewise, the current savings rate is less than half of what it was prior to the 1980s. Considering the fourth quarter marked the first post-crisis rise in household debt, consumer attitudes toward spending, saving, and debt will be important to track.

Manufacturing and Service

The ISM manufacturing index performed well during the quarter. It consistently remained in expansionary territory and rose modestly from levels in the second half of 2011. Data for March showed rising production, strong orders, and inventories that are in good shape.



Data Source: Institute for Supply Management

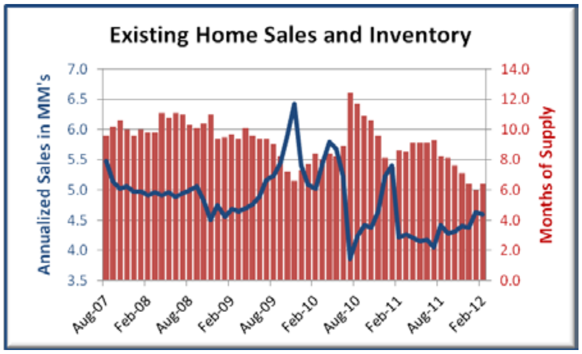
The ISM non-manufacturing index took a particularly strong jump in the new year. Purchasing and supply executives reported an uptick in business activity and new orders as well as favorable trends in both employment and prices.

Real Estate

Residential

The January Case/Shiller housing price report showed home prices continuing on a downward path. On a year-over-year basis, home prices were down 3.8%. Despite an annual decline, 10 out of the 20 geographic markets covered had sequential price increases. Furthermore, the composite index was flat on a sequential and seasonally adjusted basis.

As for transaction volumes, new home sales have not changed in two years. Existing home sales, on the other hand, have risen by about 10% over the past six months. Inventories of both new and existing homes are at healthy levels of about six months of supply each.



Data Source: S&P/Case-Shiller

The housing market is weak and will continue to face challenges. Shadow inventory (homes somewhere in the foreclosure pipeline) is down from a peak of 4.5 million but remains quite high at 3.7 million homes.

The government's $26 billion settlement with large mortgage lenders is expected to increase the foreclosure rate in 2012 and to drive more shadow inventory to hit the market faster. Sales of bank owned homes are expected to increase as well. Such forecasts appear prescient thus far as foreclosures in January were up 28%. Short sales are also on the rise.

Considering the expected rise in distressed sales, which typically sell at a 30% discount to market values, home prices will continue to be under pressure. Expectations are for 2012 to experience comparable price declines to those of 2011, about 4%.

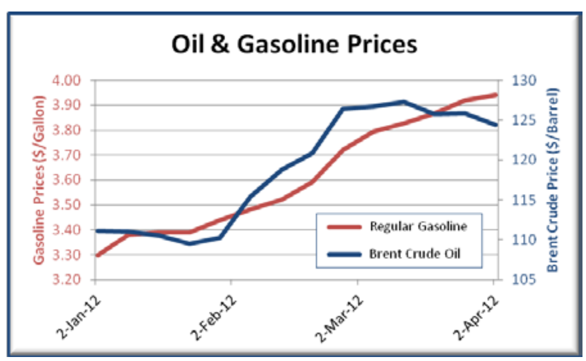
Despite problems, the industry is not devoid of hope. The National Association of Homebuilders Housing Market index reported builder confidence rose for a fifth consecutive month in February. The index is now at its highest level since May 2007. Additionally, largely due to a decrease in home prices and low mortgage rates, the National Association of Realtor's affordability index shows home ownership is the most attractive it has been in three decades.

Commercial
Commercial real estate has its own set of challenges. Rents in most commercial markets are down substantially from where they were in 2007 – some by as much as 26%.

The office market continues to degrade as landlords feel pressure from both tenant credit as well as lease re-pricing. Delinquency rates hit 9.0% in December, up from 7.4% in June, and are expected to increase. Operators are also getting hurt on the revenue side as five year leases, established at the market peak, have begun to roll off.

Malls and shopping centers had a slight increase in occupancy during the fourth quarter and rents rose modestly after 13 consecutive quarters of flat to down rates. Vacancies dropped from an 11 year high of 9.4% in the third quarter of 2011 to 9.2% in the fourth, but remain well above 2007 rates of 5.5%.

Commodities and Inflation
The Federal Reserve reports that inflation is subdued and long-term expectations are stable. Although the data confirms their views, the consumer's attention was intently focused on the spike in energy prices during the quarter.



Data Source: U.S. Energy Information Administration (EIA)

Oil and gasoline prices rose 12% and 21%, respectively and supply issues are a very real risk. The president believes global markets can withstand the Iranian oil embargo starting in July. Saudi Arabia has also vowed to bring prices down as well as make up shortfalls in output. If Obama is wrong and Saudi Arabia lacks sufficient swing capacity, strategic petroleum reserves may be tapped. In the end, the situation is tenuous and there is potential for a damaging spike in energy prices at a time when the global economy has little room for a shock.

Governments, Policy, and World Events

Fed minutes suggest little support for further monetary action. Accordingly, Operation Twist will come to its scheduled conclusion in June and hopes for a third round of quantitative easing have been dashed. For now, the Fed appears on hold. The same cannot be said for other nations including China, the U.K. Japan, and Brazil which all initiated new expansionary monetary programs during the quarter.

In February, the European Central Bank offered a second round of financing to European banks. The Long Term Refinancing Operation or "LTRO" has now infused over €1 trillion into the European banking system. The initiative initially provided a dramatic stabilization of the European financial system and strong support to sovereign debt markets. Indeed, debt auctions in Italy and Spain went well to start the year, surpassing expectations. Yields were high, but stable, and fell meaningfully in following weeks. After an initial flurry of government debt purchases, however, banks retained much of their cash infusion. Private lending did not pick up, the appetite for government debt was satiated, and bank overnight deposits at the ECB surged to extreme levels. As the quarter drew to a close, yields on Spanish and Italian debt spiked back up to pre-LTRO levels. The program's benefits may prove to be temporary and the ECB plans no further injections. Rising inflationary pressures in Europe will limit other ECB actions as well.

Other notable events for the period included:

- Congress approved extensions of the payroll tax cut as well as emergency unemployment benefits through year-end. Medicare cuts to doctors were also delayed. The total cost of the three programs is $150 billion.
- Bank stress tests in the U.S. concluded with strong results. Eighteen of the 19 major financial institutions passed. Increased dividends and share buybacks will result and investment markets reacted favorably.
- European leaders increased the size of bailout facilities to $700 billion. The IMF, central bankers from the G20, and other member of the international community deemed this amount to be insufficient. Stay tuned.
- A new European treaty was signed.
- A Greek deal was reached to provide a second round of bailout financing to the country in the amount of €130 billion. In exchange, private holders of Greek debt agreed to the largest sovereign restructuring in history. A total of €107 billion was written off in an effort to reduce the nation's debt to GDP ratio from over 160% now to 120% over time. As a result of restructuring being forced on a number of hold outs, payouts on credit default swaps were triggered.

Upcoming events and issues:

- Europe's permanent bailout facility, the ESM, will be launched in July.
- Portugal may need a second bailout as its return to the capital markets is in doubt.
- Spain's financial situation is increasingly tenuous.
- The U.S. faces a number of fiscal challenges at year-end. The Bush tax cuts expire, extended unemployment benefits cease, the temporary payroll tax cuts ends, and automatic spending cuts kick in. The total hit to GDP is estimated at 3.5%.

Capital Markets Review and Outlook

Overview

The appetite for risk came roaring back in 2012. Huge central bank liquidity, better than expected economic data, and a receding of the euro-zone crisis drove stock markets to their best first quarter start since 1998. Adding fuel to the rally were upbeat comments from the Federal Reserve and positive U.S. bank stress tests results. As an added bonus, the latter also cleared the way for increased dividends and share buybacks.

In light of the rally, this may be a good opportunity to review long-term objectives and target asset allocations. Market sentiment readings show strong bullishness among investors and stock indexes are already above some analysts' year-end targets. Adding further credence to a strategic review are the facts that insiders are selling at the fastest pace since last May and the market's fear gauge, the "VIX", indicates either a low risk Goldilocks economy or a fair amount of investor complacency.

Capital Market Returns

	1st Qtr 2012
U.S. Treasury Bills	0.0 %
Barclays Aggregate Bond	0.3 %
Barclays Municipal Bond	1.7 %
Wilshire 5000	12.9 %
S & P 500	12.6 %
MSCI ACWI ex. U.S.	11.6 %
MSCI EAFE (Int'l Equities)	10.9 %
MSCI Emerg. Mkts	14.1 %
DJ UBS Commodity Index	0.9 %

Fixed Income Markets

Aside from the credit end of the bond market, fixed income returns were uninspiring during the first quarter. A 36 basis point increase in yields across the entire 10 to 30 year end of the Treasury yield curve provided a headwind to high grade debt. As a whole, U.S. government bonds lost 1.1%. Longer dated Treasuries were off 5.8%.

Low interest rates and tighter credit spreads drove debt issuance at a frantic pace during the quarter. High yield debt issuance of $91.9 billion was the largest for a first quarter ever and the fifth largest of any calendar quarter. Emerging markets were active debt issuers as well. Yield hungry investors welcomed the issues with open arms and high yield debt gained 5.3% for the quarter.

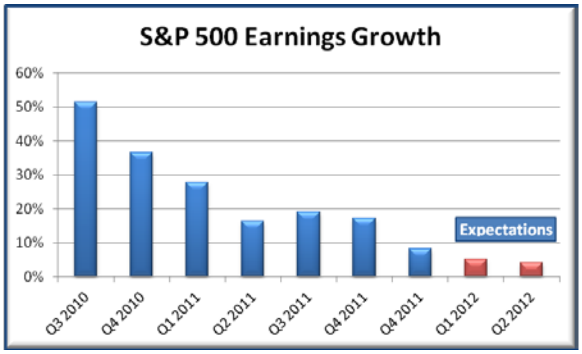
Investors also moved into mortgage bonds in anticipation of a third round of quantitative easing. Considering recent Fed comments regarding no new bond purchases, mortgage investors may rethink these positions.

Since October, the Fed's Operation Twist has absorbed 91% of newly issued 20 – 30 year Treasury bonds. The end of this program in June may put upward pressure on yields. Most forecasters believe a dramatic rise in rates is unlikely, however, as the Fed is expected to defend its goal of low interest rates.

Equity Markets

As shown in the table, stocks rose by double digits in the first quarter. Emerging markets, the best performers, were paced by gains in India and Russia. Brazil, struggling with growth, was up modestly and China was essentially flat. Emerging market currency gains were a materially positive contributor to returns.

Slowing profit growth and an increased potential for earnings disappointments should be a focal point for investors as earnings season gets underway. Standard & Poor's expects first quarter S&P 500 earnings growth of 5.2% while broader consensus expectations are dialed in at a 3.2% gain.



Data Source: Standard & Poor's Capital IQ

Considerations to keep in mind as earnings season begins:

- Weak Guidance - Fourth quarter earnings were weaker than expected and the ratio of upbeat to downbeat guidance for 2012 was the worst since 2001.
- Falling Margins - After rising steadily throughout the recovery, S&P 500 profit margins appear to have peaked late in 2011. In the fourth quarter, seven of 10 index sectors showed year-over-year profit margin compression. Sequentially, margins fell in nine of the 10 sectors.
- Earnings Pre-announcements – The first quarter of 2012 had an elevated ratio of negative to positive earnings pre-announcements.

In short, earnings outperformance can no longer be taken for granted and volatility is likely to increase from extremely low levels in the first quarter.

Hedge Funds and Alternatives

After a difficult 2011, hedge funds have not yet caught a break. The HFRI Fund of Funds index returned a disappointing 3.4% for the quarter. Market moves have been driven by unpredictable policy changes and macro swings. Such an environment poses a challenge to fundamentally driven investment managers.

Publicly traded real estate (REITs) has performed comparably to the equity markets so far this year, rising over 10%. The same cannot be said for commodities. After rising more or less in sync with stocks through February, commodities took a downward path. The catalyst came on March 5 when China cut its growth forecast to an eight-year low of 7.5%. Considering the nation accounts for nearly half of the global consumption of cement, iron ore, and coal, and over 40% of the global usage of steel, lead, zinc, aluminum, and copper, what happens to China has a direct impact on commodities. Over the 12 month period ended March 2012, commodities were the worst performing major asset class, down 16.3%.