Capital Market Review

First Quarter, 2011

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Summary

During the first quarter, investors faced uncertainty from many directions. A pro-democracy movement spread across the Middle East leading to regime change in several countries and political uncertainty in others.

Japan, the world's third largest economy, suffered a devastating earthquake and tsunami bringing economic activity to a virtual standstill.

The Euro zone is struggling to find a long-term solution to its debt crisis while many emerging market countries are taking steps to limit inflation.

Here in the U.S., the battle over the 2011 budget is nothing compared to what is coming with respect to the 2012 budget as well as trying to solve the long-term budget issues.

U.S. stocks were resilient to this news and returned 6.4% during the first quarter. Bonds returned 0.4%. Real estate returned 6.5% and commodities increased 4.5% (although several commodities, most notable oil and agriculture, had double-digit increases).

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Economic Conditions

The U.S. has had seven consecutive quarters of economic recovery. Employment has finally started to see improvement and the economy is forecast to add 200,000 jobs each month during 2011. The unemployment rate declined below 9% for the first time in a couple of years. Personal income is rising and retail sales are pretty strong. Productivity remains high. Businesses are solidly profitable and, generally speaking, have strong balance sheets. Banks are starting to lend again and consumers are continuing to improve their balance sheets. Future indictors of economic activity such as leading indicators, new orders, purchasing managers, and consumer sentiment are all pointing toward continued economic growth.

However, there are risks. The most severe near-term risk is with respect to the political uncertainty around the Middle East and the price of oil (as well as the price of many other commodities). The price of oil increased over 15% during the past three months. An oil price spike preceded each of the last five U.S. recessions.

The price of many agricultural commodities has risen more than the price of oil. Americans are becoming more skeptical of the Federal Reserve's statements that inflation is not a problem when the costs of things they use every day keep increasing. The bond market is becoming more concerned about rising inflation and the Fed's easy money policies.

Housing data was not strong during the first quarter as both sales and prices declined. There remains a large number of mortgages that are either delinquent or in foreclosure. This will further pressure prices. Clearly, there is no sign of a sustained recovery in the housing market.

The state of the U.S. budget is of significant concern. Standard and Poors, the large rating agency, recently changed its outlook on U.S. debt from stable to negative. The rating has not changed, just the outlook. But if something is not done relatively soon, a debt downgrade may be next.

The good news is that it appears lawmakers are gearing up for an attempt at real entitlement and tax reform. There certainly will be a lot of talk and posturing. Unfortunately, we are not overly optimistic of significant action prior to the 2012 presidential election. It will be difficult enough to get a 2012 budget in place, let alone find long-term solutions.

It is not overly dramatic to say that solving the budget crisis will likely be the major issue of our generation. It is the future of our country and our children that we will be discussing. The solutions will be unpopular. All segments of society will (and should be) affected. Saying "not me" is no longer a viable alternative in terms of who must contribute (pay) for the solution.

On the international front, due to the devastation of the earthquake and tsunami, Japan will likely enter into a recession. Since Japan is more of an export-driven economy, the impact on the world economy should be relatively modest. However, one unknown is whether companies can shift their supply chains from Japan to other countries to obtain component parts.

The Euro-based countries do not seem to have a long-term solution to the sovereign debt crisis and will probably continue to "muddle through". Many of the largest emerging market countries are in a policy tightening phase in an attempt to sustain growth while avoiding overheating their economies.

Forecasts for 2011 U.S. real GDP growth are around 3.5%. Unless there is a change in the direction of commodity and agricultural prices, our sense is that the back half of the year may be weaker than current expectations -- not only for the consumer but for business as well. We do expect another recession. However, if commodity prices (in particular oil and agricultural) continue their increase, we cannot eliminate the possibility.

Stock Market

There is an old adage that says stocks like to climb a wall of worry. Well, the wall was pretty high during the first quarter. Between the political crisis, commodity price increases, the tragedy in Japan, and the tragedy that is the U.S. budget.

U.S. stocks returned 6.4% during the first quarter. It appears that business leaders are becoming more confident of a sustained economic expansion and are planning accordingly. Both earnings growth and corporate profit margins are strong but have probably peaked. Even so, earnings forecasts for large stocks still suggest significant growth of over 15% for 2011 and 14% for 2012. Mid and small-cap stocks have even higher expectations. Profit margins will likely be impacted by new hiring as well as higher operating (commodity) costs.

U.S. stocks outperformed both the developed international and emerging market returns of 3.4% and 1.7%, respectively. Mid and small stocks continued their dominance over large stocks and returned 7.6% and 7.9%, respectively. Large stocks returned 5.9%. The value, core, and growth investment approaches returned essentially the same with returns of 6.5%, 6.4%, and 6.3%, respectively.

The energy sector returned 16.8% with the next best performing sector being industrials at 8.8%. Consumer staples, utilities, and finance were the laggards returning 2.5%, 2.7%, and 3.0%, respectively.

Forward-looking price/earnings ratios (using expected earnings), suggest that the market, particularly large-cap stocks, is still relatively attractive. This, of course, assumes that the expected earnings growth materializes. 2011 price/earnings ratios are 13.7x, 18.5x, and 19.6x for large, mid, and small stocks, respectively. Clearly, from a valuation perspective, mid and small-cap stocks are less attractive. By some measures, they are more expensive, relative to large-cap stocks, than at any point in the past 20 years. In addition, mid and small stocks assume earnings growth that we do not believe is sustainable.

Based on our valuation work (a summary of which is on page 4) , we believe large-cap stocks are the most attractive company size segment. And yet, from a technical perspective, small-cap stocks continue to outperform. Unfortunately, mis-valuations can occur for relatively long periods of time (think of the internet and/or real estate bubble). We have gradually reduced our small-cap overweighting, but until the technical trends also turn, we will likely remain marginally overweight to small cap stocks.

Bond Market

Except for the shortest-maturity bonds, interest rates had small increases (0.10% to 0.15%) across the maturity spectrum. Interest rates still remain lower than a year ago. The Federal Reserve's quantitative easing program ends in June (the Fed purchased U.S. securities in an effort to keep bond yields low). The program's end will probably not significantly effect yields since it has been well communicated. Although, over time, not having such a large buyer may put upward pressure on interest rates. The elimination of this program is likely the first step in a line of policy moves that will, eventually, return us to more normal policy and interest rate conditions.

Developed and emerging market bonds each returned 0.9% during the first quarter, ahead of the U.S. market return of 0.4%. High yield and inflation-protected bonds returned 3.9% and 2.1%, respectively. Municipal bonds returned 0.5%.

Corporate bonds were the best performing sector outperforming mortgage-backed and government bonds. From a maturity standpoint, long-term government bonds returned -0.9%. Other government-bond maturity segments were essentially flat.

Inflation expectations are creeping into bond yields as the spread between the five-year Treasury and the five-year Treasury Inflation Protected Note is at its widest point since 2008. Even so, the spread is only modestly above its long-term average suggesting that, while inflation expectations are rising, they are not far from normal levels.

During 2011, we expect a small rise in interest rates (perhaps in the 0.5% range). While shorter-term rates may increase, we expect most of an interest rate increase to be concentrated in the intermediate- to long-term maturity segments.

More On The Budget

In a recent monthly update, Bill Gross, the head of the world's largest bond fund, provided the following table on the 2011 federal budget and where money is spent.

2011 Federal Spending By Category

	% Of Budget
Entitlement	44%
Defense	24%
Discretionary	25%
Interest Payments	7%
	100%

The entitlement category is made up of Social Security, Medicare, and Medicaid. It currently represents 44% of federal spending and is rapidly increasing. The discretionary category is the "catch all" bucket and represents things like education, infrastructure, research and development, and housing programs. The simple math is that you cannot effect budgetary change without impacting Social Security, Medicare, and Medicaid.

Furthermore, while not shown, the U.S. has a net present value of $66 Trillion in **unfunded liabilities**. These future costs, discounted to today, assume spending continues at the projected demographic rate. Compare this $66 Trillion in unfunded liabilities to the 2010 U.S. revenue budget of $2.2 Trillion.

As Tom Hanks once famously said: "Houston, we have a problem". This is not a Republican or Democratic problem. This is an American problem that we must solve together. The Peter G. Peterson Foundation website (www.pgpf.org) is an interesting place to learn more.

Stock Returns For Periods Ending March 31, 2011

	Qtr	Ytd	1 Year	3 Year	5 Year
Nationality					
U.S. Market	6.4%	6.4%	17.4%	3.4%	3.0%
Developed Intl	3.4	3.4	10.4	-3.0	1.3
Emerging Market	1.7	1.7	15.9	2.0	8.3
Size					
Large	5.9	5.9	15.7	2.4	2.6
Mid	7.6	7.6	24.3	7.3	4.7
Small	7.9	7.9	25.8	8.6	3.4
Micro	5.7	5.7	25.5	9.4	1.1
Approach					
Value	6.5	6.5	15.6	1.1	1.4
Core	6.4	6.4	17.4	3.4	3.0
Growth	6.3	6.3	19.3	5.6	4.3
Sector					
Cons Discretionary	4.7	4.7	21.0	10.1	4.7
Cons Staples	2.5	2.5	10.6	5.1	7.9
Energy	16.8	16.8	39.8	4.0	9.8
Finance	3.0	3.0	4.0	-11.1	-10.7
Healthcare	5.6	5.6	5.1	4.3	2.7
Industrials	8.8	8.8	21.9	1.4	3.5
Technology	3.5	3.5	11.9	7.3	4.9
Materials	4.5	4.5	24.2	2.1	6.9
Telecomm	4.9	4.9	30.4	3.1	4.8
Utilities	2.7	2.7	12.3	-1.5	4.7

	Qtr	1 Year	3 Year
Developed Country			
U.S.	6.4%	17.4%	3.4%
Canada	7.2	20.1	3.4
Europe	6.5	12.6	-4.2
France	10.5	7.3	-7.5
Germany	7.2	17.0	-6.2
Italy	13.8	1.1	-14.6
United Kingdom	2.8	9.9	-6.0
			-
Pacific	-2.0	6.9	-0.3
Australia	3.2	10.3	1.5
Hong Kong	-0.8	16.3	2.4
Japan	-5.9	-0.6	-5.4
Emerging Market			
China	2.9	6.6	1.6
India	-5.2	7.7	2.7
Korea	6.5	29.4	5.0
Czech Republic	16.3	6.1	-11.3
Hungary	20.2	-5.0	-6.8
Poland	6.9	15.7	-9.0
Russia	16.3	26.7	-7.5
Brazil	2.0	3.3	0.7
Chile	-8.3	28.8	10.3
Mexico	0.5	15.6	0.6

Stock Fundamentals As Of March 31, 2011

	United States		Developed		Emerging	
	Current	1 Year Ago	Current	1 Year Ago	Current	1 Year Ago
Price/Earnings Current	16.5	17.5	14.4	13.2	14.5	6.0
Price/Forecast Earnings	14.6	15.5	12.2	13.5	11.9	13.7
Price/Book	2.3	2.2	1.6	1.6	2.2	1.6
Price/Cash Flow	9.7	8.9	6.8	6.8	7.0	6.6
Price/Sales	1.4	1.2	0.9	0.8	1.3	1.4
Forecast LT EPS Growth	10.2	9.8	9.4	7.4	16.3	14.5

	Est. P/E Ratio		Est. EPS Growth		2011 Forecast Returns			2012 Forecast Returns		
	2011	2012	2011	2012	15x	20x	7% DR	15x	20x	7% DR
Large	13.7x	12.0x	15.4%	13.9%	9.4%	45.9%	4.2%	24.6%	66.1%	18.6%
Mid	18.5	15.5	21.9	19.3	-18.8	8.3	-22.7	-3.1	29.2	-7.7
Small	19.6	15.9	34.1	23.3	-23.5	2.1	-27.1	-5.7	25.8	-10.2

Bond Returns And Characteristics For Periods Ending March 31, 2011

Returns

	Qtr	Ytd	1 Year	3 Year	5 Year
Nationality					
U.S. Market	0.4%	0.4%	5.1%	5.3%	6.0%
Developed Intl	0.9	0.9	9.8	4.0	8.2
Emerging Market	0.9	0.9	8.6	8.7	8.2
Maturity (Government)					
Cash	0.0	0.0	0.1	0.4	2.1
Short-Term	0.1	0.1	2.7	3.1	4.9
Intermediate-Term	0.0	0.0	3.8	3.5	5.5
Long-Term	-0.9	-0.9	7.4	4.1	6.3
Sector					
Corporate	0.9	0.9	7.0	7.0	6.4
Government	-0.1	-0.1	4.3	3.7	5.6
Mortgage	0.6	0.6	4.4	5.9	6.5
Other					
High Yield	3.9	3.9	14.3	12.9	9.1
Inflation Protected	2.1	2.1	7.9	3.9	6.3
Municipal	0.5	0.5	1.6	4.5	4.1

U.S. Bond Yields	Qtr	Last Qtr	1 Year Ago
Fed Funds	0.13%	0.19%	0.16%
Prime Rate	3.25	3.25	3.25
3 Month Treasury	0.10	0.12	0.16
1 Year Treasury	0.30	0.29	0.44
3 Year Treasury	1.28	1.07	1.65
5 Year Treasury	2.21	2.06	2.60
5 Year TIP	0.02	0.24	0.77
10 Year Treasury	3.47	3.38	3.88
30 Year Treasury	4.52	4.43	4.75
Aaa Corporate	5.16	4.96	5.37
Baa Corporate	6.06	6.05	6.36
Barclays Aggregate	3.45	3.49	3.81
Barclays Credit	4.51	4.55	4.88
Barclays Treasury	2.02	2.02	2.09
Barclays Mortgage	3.43	3.46	3.61
Barclays Municipal	3.58	3.69	3.75
Barclays High Yield	8.65	9.27	11.76
Citi Intl Treasury	2.26	2.27	2.16
JPM Emerging	5.14	5.19	5.53

10-Year Sovereign Bond Yields

Developed Mkts	Qtr	Last Qtr	Mar 2010
United States	3.34%	3.52%	3.82%
Canada	3.29	3.44	3.66
France	3.60	3.37	3.40
Germany	3.22	3.02	3.07
Italy	4.75	4.54	3.91
United Kingdom	3.54	3.73	4.00
Euro Zone	3.23	2.97	3.07
Australia	5.43	5.67	5.69
Hong Kong	2.44	2.62	2.49
Japan	1.19	1.24	1.31
Emerging			
Brazil	6.16	6.16	6.16
China	3.94	3.82	3.29
India	8.20	8.32	8.19
Russia	4.80	5.78	6.29

Spreads Versus 10-Year Treasury

	Qtr	Last Qtr	1 Year Ago
Aaa	1.69	1.58	1.49
Baa	2.59	2.67	2.48
Barclays Aggregate	-0.02	0.11	-0.07
Barclays Credit	1.04	1.17	1.00
Barclays Treasury.	-1.45	-1.36	-1.79
Barclays Mortgage	-0.04	0.08	-0.27
Barclays Municipal	0.01	0.31	-0.13
Barclays High Yield	5.18	5.89	7.88
Barclays TIP	-0.98	-1.05	-1.83
Citi Intl Treasury	-1.21	-1.11	-1.72
JPM Emerging	1.67	1.81	1.65
Maturity (10yr-1yr)	3.17	3.09	3.44
Implied Inflation	2.19	1.82	1.83

Commodity, Real Estate, & Currency Returns
For Periods Ending March 31, 2011

	Qtr	Ytd	1 Year	3 Year	5 Year
Commodity					
DJ UBS Commodity	4.5%	4.5%	28.5%	-5.2%	2.6%
CRB Commodity Spot	10.5	10.5	33.4	7.4	12.9
CRB Fat & Oils	18.1	18.1	54.1	8.3	21.4
CRB Foodstuffs	15.2	15.2	47.3	10.5	16.0
CRB Livestock	17.9	17.9	36.4	9.6	14.7
CRB Metals	8.0	8.0	28.3	1.3	15.5
CRB Raw Industrials	7.4	7.4	24.5	5.2	10.8
CRB Textiles & Fibers	7.9	7.9	27.8	11.9	8.1
Agriculture					
Coffee	24.1%	24.1%	81.6%	25.8%	21.3%
Corn	13.3	13.3	53.8	5.1	21.5
Soybean	4.3	4.3	28.9	1.7	16.8
Sugar	15.3	15.3	35.1	11.5	16.0
Wheat	18.3	18.3	62.3	-10.4	15.0
Energy					
Oil	15.6%	15.6%	26.7%	-0.8%	10.4%
Unleaded Gas	16.7	16.7	27.0	3.0	6.9
Metals					
Aluminum	8.4%	8.4%	15.6%	-5.3%	1.0%
Copper	3.8	3.8	27.3	4.1	13.2
Gold	2.4	2.4	27.9	13.7	20.6
Nickel	10.8	10.8	18.9	-4.9	12.3
Zinc	6.8	6.8	37.7	-4.0	15.1
Real Estate					
MSCI U.S. Reit	6.5	6.5	24.3	2.2	1.4
MSCI World Reit	2.4	2.4	19.7	-2.4	-0.1
Currency		**U.S. Dollar Return**			
Euro	-6.1%	-6.1%	-3.3%	3.3%	-3.1%
Japan	-2.0	-2.0	-10.0	-6.8	-7.0
U.K.	-3.6	-3.6	-7.3	6.9	1.5
Brazil	-2.1	-2.1	-7.1	-1.0	-5.1
China	-1.3	-1.3	-3.8	-2.4	-4.0
India	-0.3	-0.3	-1.1	3.8	0.3
Mexico	-3.2	-3.2	-4.5	3.8	2.2

Summary of Current Economic & Financial Conditions

	Percent Change					
	3 Month % Change	3 Month % Change Annualized	6 Month % Change	6 Month % Change Annualized	1 Year % Change	Data As Of
Gross Domestic Product	0.77	3.11	1.41	2.84	2.78	December
Leading Economic Indicators	1.89	7.76	3.00	6.08	5.00	February
ECRI Weekly Leading Index	1.88	7.75	6.34	13.09	-2.73	April
Personal Income	1.93	7.95	2.74	5.56	5.06	February
Retail Sales	2.43	10.10	6.22	12.82	9.50	February
Retail Sales Excluding Motor Vehicles	1.58	6.48	4.44	9.07	6.32	February
Industrial Production	1.01	4.12	2.57	5.21	5.88	March
Number of Unemployed	-6.51	-23.61	-8.16	-15.66	-9.38	March
Announced Layoffs	29.76	183.50	11.78	24.95	-38.58	March
Output Per Person	0.63	2.53	1.64	3.30	3.24	December
CPI - All Urban Consumers	1.38	5.64	1.93	3.89	2.16	February
Personal Consumption Expenditures	0.99	4.02	1.59	3.20	2.61	December
PPI - Finished Goods	3.29	13.81	4.90	10.03	5.78	February
CRB Commodity Spot Index	10.51	49.17	18.02	39.28	33.37	March
Gold Price	2.41	9.98	12.03	25.51	27.90	March
Oil Price	15.61	78.65	36.69	86.84	26.71	March
Housing Starts	-12.59	-41.63	-21.99	-39.14	-20.83	February
New Single Family Home - Sales	-12.59	-41.62	-8.76	-16.75	-27.95	February
New Single Family Home - Median Price	-8.50	-29.91	-13.56	-25.28	-8.85	February

	Actual Value / Diffusion Index				
	Current Value	3 Months Ago	6 Months Ago	1 Year Ago	
Phili Fed Survey - General Activity - 6 Months Ahead	63.00	55.40	28.20	50.50	March
Phili Fed Survey - New Orders - 6 Months Ahead	60.10	49.90	23.10	47.60	March
Consumer Sentiment	77.50	71.60	68.90	73.60	February
ISM Purchasing Managers Index	61.20	58.48	55.28	60.36	March
Capacity Utilization - Total	77.01	75.92	75.48	72.19	February
Unemployment Rate	8.80	9.40	9.60	9.70	March
AAII Percent Bullish Investor Sentiment 8 Week Average	38.45	52.40	47.41	40.65	April
AAII BullBear Investor Sentiment Spread	14.74	7.75	29.63	12.72	April
S&P 500 PE	17.17	16.58	15.90	19.01	April
S&P 500 PE Using 10 Year Average Earnings	23.47	22.97	21.23	21.80	April
VIX - Volatility Index	18.35	23.54	26.05	19.50	February
3 Month Treasury Yield	0.10	0.12	0.16	0.16	March
1 Year Treasury Yield	0.30	0.29	0.27	0.44	March
5 Year Treasury Yield	2.21	2.06	1.28	2.60	March
10 Year Treasury Yield	3.47	3.38	2.52	3.73	March
30 Year Treasury Yield	4.52	4.43	3.69	4.75	March
Aaa Corporate Bond Yield	5.16	4.96	4.51	5.37	March
Baa Corporate Bond Yield	6.06	6.05	5.58	6.36	March
Quality Spread (Baa - Aaa Bond Yield)	0.90	1.09	1.07	0.99	March
Term Spread (10 Year - 1 Year Treasury Yield)	3.17	3.09	2.25	3.29	March
Real Yield Spread (10 Yr TBond- 1 Yr Expected Infl)	0.17	0.08	0.32	1.03	March