



Craig Cairns,
President

The Equity Market

A Global Perspective

By Craig Cairns

A snapshot of the globe today depicts a pretty bleak picture: political upheaval in Libya and other neighboring Middle Eastern countries leading to much higher oil prices and still another war, the devastating earth quake and tsunami in Japan, more debt default concerns in several European countries, and unemployment and economic recovery in the United States that is anything but a straight line upward.

Sailing On, Despite the Storm

Yet equity investors seem barely bothered as the stock market shrugged off lots of international worry in the first quarter of 2011, continuing where it left off in 2010 as the S&P 500 blasted to a 5.9% return for the quarter. And in the face of rising oil and food prices, combined with increasing inflation concerns, even the bond market squeaked out a slightly positive return.

Investors continue to be able to separate the improving economic conditions, especially in the United States, from the more unstable international situation. We believe it is true that if the world were a safer place right now (a big, maybe meaningless "IF," especially if the Middle Eastern upheaval worsens) that the stock market strength is justified. We have continued to slowly reposition the portfolio to take advantage of continued recovery with one eye fixed squarely on the global situation.

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Vince Russo,
Vice President, Director
of Fixed Income Research

The Bond Market

1st Quarter Overview

By Vince Russo

In light of loss of life and the suffering that is occurring in the Middle East and Japan, our discussion about portfolio performance and economic growth may create an impression of being insensitive, but it is our responsibility to safeguard our clients' capital and to be objective about the economic prospects that lie ahead.

The bond market has made a slight comeback this past quarter after the markedly negative returns of the 4th quarter of 2010. Most major subsectors of the Barclays index showed positive returns with the exception of the US Treasury: Intermediate sector. This is somewhat surprising given the major geo-political disturbances around the world, as well as the natural disaster that fell upon Japan. The US Treasury market is normally the safe haven for capital when there is global instability. Yet, during this particular period of uncertainty, US Treasuries were not the major beneficiaries. However, the current yield on the 10-yr Treasury Note (as of this writing) is approximately 3.48%; much lower than the high yield of 3.74% on February 8, and significantly higher than the low yield of 3.17% from approximately two weeks ago on March 16.

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To the Shores of Tripoli

The events of the first quarter were remarkable in the magnitude of their potential ramifications for the entire world. A deeper look beyond the snapshot of the globe referenced in the first paragraph is in order, in an attempt to make sense of current events and what they continue to mean for investors. The upheaval touched off with the self-immolation of a street vendor protesting government harassment in Tunisia, and quickly spread to Egypt, which is very important to the security of the region.

Egyptians demonstrated mostly peaceably, but in extraordinary numbers, to express dissatisfaction with being led by an autocratic ruler for many years, and the resulting economic stagnation of their country. This was followed with similar demonstrations across the Mideast in places as unlikely as Yemen, Bahrain, and even Saudi Arabia, and Syria finally manifesting itself with a violent uprising against the 40-year rule of dangerous and violent Libyan strong-man Muammar Qaddafi.

The market liked it less prior to United Nations military involvement when the possibility of wholesale massacre of the rebels opposing Muammar el-Qaddafi seemed imminent. However, now that the West solidified its role (although with objectives that are still somewhat fuzzy) by becoming directly involved in airstrikes in Libya, although it seems evident that unrest will not be diminishing anytime soon the situation is better for the rebels.

In the midst of the unrest in the Middle East, the horrific earthquake and tsunami struck the Northern part of Japan, killing an untold number of Japanese and knocking out the nuclear power plants that began to leak radiation. Japan has the world's third largest economy. In addition to being disastrous in terms of human life, it was unclear immediately how bad the impact would be on the global economy.

The Market Reacts

We thought the stock market responded appropriately, without a severe overreaction to the unrest in the Middle East and the earthquake in Japan. The market shed most of the 4% gain it had achieved for the year to date in early March. Investors adopted a wait and see approach and evaluated the impact of higher oil prices and the potential slowdown to the Japanese economy on the rest of the world. The VIX Market Volatility Index (also known as the fear gauge) jumped quite aggressively as the news of the radioactivity in Japan and the Libyan crisis changed daily. Oil prices continue to be volatile on the uncertainty in Libya, settling at the time of this writing at \$108/barrel.

While bonds have had a rougher go of it the past two quarters as the global outlook and the outlook for stocks has improved, clients rediscovered the benefits of balanced portfolios as the bond market rallied in the face of the uncertainty. Although, the flight to safer assets was followed by widespread concern that, in an effort to rebuild, Japan may have to pull billions of their investment dollars out of foreign markets, including that of the United States.

According to Reuters contributors Natsuko Waki and Jeremy Gaunt in their article, "Analysis: High-yield and U.S. debt at risk if Japan repatriates," Japan has about \$890 billion invested in United States Treasuries. Repatriation, therefore, could have a negative impact on the price of US bonds.

Economic Strength in the Face of International Uncertainty

The good news is that the US economy continues to grow. We have long-talked about the necessity for employment, bank credit, and housing prices all to strengthen for there to be a healthy and long-lasting recovery. All signs are that bank credit has been loosening as banks have started to make loans in a meaningful way. On Friday, April 1st headlines revealed that US employment data was stronger than expected, with a payroll increase of 216,000, noteworthy for the private sector job growth. Additionally, the unemployment rate fell from 8.9% to 8.8%. While still not a great number, the rate continues to move in the right direction. (On that same day, the ISM Manufacturing Index also maintained a strong reading at 61.2, from 61.4 the previous month.)

The Missing Link

Housing is the missing piece to the recovery as the Case Shiller home price index continues to fall. An improving housing sector is the critical component for this economic recovery because housing drove the current economic crisis.

The Fed has bought back \$350 billion of securities as part of Quantitative Easing II, the plan to purchase \$600 billion worth of securities by June. Inflation fears driven by rising energy and food prices have led some of the Fed members to become increasingly hawkish, rumbling about suspending the rest of the Quantitative Easing II and beginning to raise interest rates in the near term. However, housing prices are extremely important to economic recovery, especially because housing drove the economic crisis. Fed Chairman Ben Bernanke seems determined to finish the easing which is likely to bode well for the stock market, but may be causing serious inflationary storm clouds to gather.

Making Money is Good

We enjoyed the first quarter's increase in the stock market despite the world careening from international crisis to international crisis. Japan continues to slowly pull itself from the rubble, Libya continues to rage and the rest of the Middle East continues to smolder with little certainty as to whether the region will stabilize. Economically, the United States continues to move forward, led by improving corporate profits, positive cash flow, strong corporate balance sheets, bank lending, and employment. Stocks are modestly priced compared to historical norms and earnings gains, interest rates, and inflation levels.

We are well-positioned to take advantage of improving economic strength while not losing sight of the fact that the world's markets continue to be volatile and challenging. As has happened so often in the past, the stock market is indeed "climbing a wall of worry."

Start Date: 12/30/2010 End Date: 3/29/2011

Index	Return for Period
Intermediate U.S. Government / Credit	0.19%
U.S Treasury: Intermediate	-0.19%
U.S. MBS Agency Fixed Rate MBS	0.34%
U.S. Agency: Intermediate	0.12%
Intermediate: Corporate	0.93%
Intermediate Utility	0.61%
Invest. Grade: Industrial - Intermediate	0.74%
Invest. Grade: Financial Institutions - Intermediate	1.24%
U.S Treasury Inflation Notes: 5+ Years	1.31%
Municipal Bond: 1-10 Yr Blend (1-12)	0.89%

Source: Barclays Capital

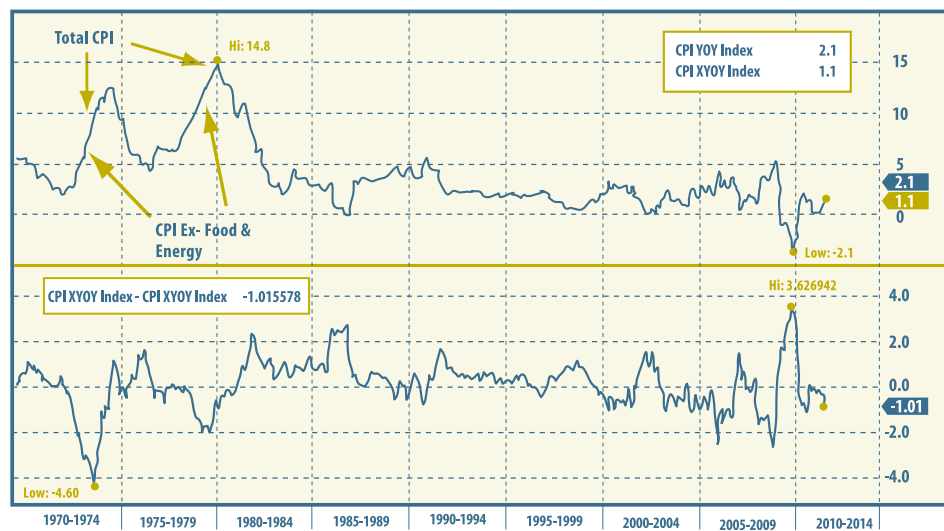
Please note: The returns above are for a 3-month period only.

While the bond market has benefitted somewhat from the usual flight to safety trade during this period of uncertainty, the capital markets are much more wary of inflationary signals that are growing louder in the global economies around the world. Of particular concern are rising prices of commodities like oil and food. In fact, much of the unrest in the Middle Eastern Arabian countries is not directly attributable to ideological differences between the government and its peoples, but rather to something much more basic – jobs and food. High unemployment and quickly rising food prices make it much harder to feed one’s family. The problem becomes more complex when the political unrest is concentrated in an area that accounts for a significant portion of the world’s crude oil supply. So, the big economic concerns troubling us at the moment really are attributable to the fear of inflation taking hold, the devaluation of our currency as a result of the easy monetary policies of the Federal Reserve Bank, and the possible loss of purchasing power that results from inflation. This fear is becoming pervasive and it would appear to outweigh the potential for slower global growth because of the natural disaster of Japan’s earthquake and tsunami and the Middle East instability. Are these fears justified? One can only answer that question after the fact. Economic conditions in this country (and elsewhere) are very “fluid” and are affected dynamically by many, many variables. It is not simply a matter of looking at one or two (albeit important) economic variables and being able to draw conclusions of what the outcome will be with great certainty.

We’ve attempted to take a closer look at the inflation implications of the relationship between Total CPI (Consumer Price Index) and CPI Ex-Food and Energy (Core Consumer Price Index). The chart below graphs the two measurements of price inflation over approximately the last 40 years (1970 to Present). We can see that rapid increases in Total CPI led to subsequent increases in Core CPI in the past, on two occasions. It just so happens that those instances occurred 30 to 35 years ago. The high inflationary times from the mid 1970s to the early 1980s were very turbulent and volatile for our economy. Our economy then was also struggling with high unemployment as well as high inflation (stagflation).

The average annual unemployment rate jumped from 5.6% in 1974 to 8.5% in 1975. It stayed persistently high (above 7%) in 1976 and 1977, before gradually declining to approximately 6% in 1978 and 1979. However, the following 7 years (1980 through 1986) saw the average annual unemployment rate above 7% with 1982 and 1983 almost approaching 10%. One of the major differences in comparing unemployment back then and now is that it would appear that unemployment then increased as a result of inflationary pressures whereas now, we are starting at a higher

Total CPI (Consumer Price Index) & CPI Ex-Food and Energy (Core Consumer Price Index) 1970- Present



Source: Bloomberg LLP

level of unemployment as a result of the most recent deflationary pressures. As a matter of fact the Federal Reserve’s Monetary Policy Dual Mandate – “to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates” was added by amendment in 1977 to the original Federal Reserve Act of 1913. This was no doubt Congress’ response to the political pressures brought about by the high rate of unemployment during the mid 70s.

The picture since those times is substantially different. The above chart shows that the relationship between the measurements of inflation (Total CPI and Core CPI) are correlated, but they have not necessarily followed in “lock-step” all of the time. We can see that Total CPI used to be a better leading indicator of an increase or decrease in inflation at the core level. However, over the last decade or so we have seen Total CPI being more volatile while the Core CPI has been much less so. Therefore, it is not clear that this correlation always holds. It is precisely because of the volatile nature of food and energy prices, that there is currently a huge debate over whether or not these price increases are temporary or longer lasting enough to spread to general price increases in other goods and services. We, like many others, are uncertain about the lasting effects of commodity price increases on Core inflation and the general level of interest rates. We can see a number of variables that would act as a counterbalance against high growth and inflation rates:

- Unemployment still at high levels – approximately 9%, but slowly improving. However, we believe that the rate of unemployment is understated because of those who are currently not actively seeking employment and have really dropped out of the employment pool of potential workers. Furthermore, we expect the potential for more unemployed from the public sector as states and municipalities struggle with balancing budgets. These jobs will not be easily absorbed by the private sector.
- Personal income continues to increase at a slow rate. Workers do not have the ability to demand higher wages in a labor market that has a great deal of slack (under-utilized). The biggest cost that most employers have is labor. Employment costs continue to be subdued.
- Depressed housing values will continue to be an anchor against high inflationary pressures. The continued supply of existing home inventory is notably high. This is still very much a recession in housing.
- High indebtedness at all government levels means fiscal restraint will be necessary. In an economy that is driven by consumption of goods and services, the biggest consumers – governments -- will be reducing their discretionary expenditures. In many cases some municipal governments will be facing austerity budgets when it comes to discretionary spending. This is not going to be a short-lived problem. We would expect the fiscal imbalances of state and local governments will be a bigger problem next year as our economy continues to grow below its full potential.

While we can point to a number of factors that should keep inflation from spreading, we are also realistic about the likelihood of interest rates increasing. The unprecedented easy monetary policy of the Federal Reserve will most likely be coming to an end no later than June 2011. That coincides with the end of the asset purchase program (Quantitative Easing) the Federal Reserve Bank has been engaged in since last November. The question now is how the Federal Reserve will reverse almost \$2 trillion of purchases that it has made over the last two years? Will there be demand for the assets? The simple answer is yes, but at what price? The capital markets will ultimately determine the price and it will most likely be lower than it is today. So, we would expect the yields (interest rates) to rise in order to stimulate further demand for these assets. The degree to which interest rates increase will be subject to many other variables. It will depend on alternative investment opportunities, risk appetite, and the need for liquidity.

As investment managers we are focused on the longer term but are keenly aware of the short-term market volatility that makes asset allocation and investment decisions much more challenging. We have continued to underweight our position in US Treasury securities, while increasing our positions in corporate bonds. We have attempted to reduce the overall duration of our portfolios and have taken a more defensive posture on managing interest rate risk. We do expect much more volatility as the market attempts to absorb the changes in monetary policy and fiscal policy. We have come to a point in time where our economy may need to stand on its own, without government intervention. The outcome of less intervention in the capital markets is still questionable. It remains to be seen if taking away the massive liquidity provided by government programs can be easily replaced by the market.

¹ U.S. Bureau of Labor Statistics Database – Seasonally adjusted 16 years or older.