



Economic Commentary and Capital Market Update

June 2011

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Overview: Data released this month provide signals of a slower pace of economic growth in the second quarter; a number of indicators highlight the economy's disappointing performance. Most obvious is the lackluster GDP growth during Q1 which shows slower consumer spending. We had been willing to overlook a slowdown in spending growth, since the job market finally appeared to be showing momentum. But even here the recent data give pause to our optimism. May job growth was anemic at best and initial jobless claims have trended higher. Manufacturing activity, which drove the economic recovery in the last two years, has also softened.

Much of this slowdown can be attributed to global factors. *Firstly*, the debt of European sovereigns remains an immediate concern. We have been saying since early last year that restructuring Greek debt was inevitable. While we expect this to happen during 2011 or early 2012, discord between the European Central Bankers and European politicians has made timing this eventuality uncertain, leaving global markets in a state of anxiety. *Secondly*, political crisis, escalating civil war and violence in different parts of the Middle East are all feeding into the risk premium on oil prices and the will of consumers to spend. *Lastly*, on top of these pressures, slowing economic growth in China and supply chain disruptions following Japan's earthquake have stunted reliable sources of demand for manufactured exports.

This arguably paints a gloomy picture. But, thankfully, much of our optimism remains intact. Although consumer spending has slowed, the composition of current growth has become more balanced with a shift away from government spending and inventory accumulation and towards private demand. Second, even while jobless claims have remained stubbornly high, the pace and substance of employment growth has improved with the service sector making up the bulk of recent new hiring. Finally, there has been noticeable improvement in the supply and demand for loans – the lifeblood of any recovery. So, even as data disappoints, *investors should remain hopeful that the balance of risks are not nearly as one sided as they first appear.*

GDP: The U.S. economy has stumbled deeper into another soft patch with revised estimate of Q1 2011 GDP coming in at 1.8%, slightly below our expectations but identical to the previous initial estimate. Final domestic demand was revised down while inventories were revised upward. The recent setbacks in economic indicators are not a complete surprise. Higher oil prices and the impact of the Japanese earthquake on global supply chains did disrupt the trajectory of economy activity. The latest data suggest the recovery will continue to be slow and painful and is likely to yield job gains that aren't sufficiently robust to restore the labor market's health anytime soon. Despite these headwinds, we expect Q2 GDP growth to be in the 2.5% range.

Consumer Confidence: Consumer confidence fell 5.2 points to 60.8 in May, its lowest level since November of last year. Consumers face a litany of concerns, including high unemployment, stagnant wages and another slip in the housing market. They voiced a bit more concern about the near-term economic situation and are less optimistic that conditions will improve anytime soon. The latest numbers add to concerns about a slowing economy.

Personal Income: Americans spent a little less freely last month suggesting the economic recovery is losing some momentum as people feel the pinch of higher food and gas prices. Both consumer spending and personal income rose by 0.4% in April after rising 0.5% a month earlier. Unfortunately, rising food and energy prices represent the bulk of the gains. Spending on services was the only category to show a noticeable gain, rising

by only 0.1%. Spending on durable goods and non-durable goods was virtually flat. The personal saving rate remained unchanged from a downwardly revised 4.9% in March. While recent data have not been encouraging, we expect spending growth to accelerate in the coming months. The labor market has been improving and credit conditions have eased while interest rates remain low.

Durable Goods: Durable goods orders fell 3.6% in April. New orders fell 1.5% with declines concentrated in transportation and motor vehicles and parts. Core capital goods orders – a proxy for business investment activity – fell 2.6%. April's decline in durable goods orders is as much a reflection of transitory headwinds as it is a reflection of the indicator's volatility. The effect of the Japanese earthquake on U.S. manufacturers finally affected industrial production data. Once the effect of earthquake works out through the system, we expect durable goods orders to return to positive territory. A weak dollar should also increase overseas demand for U.S. durable products.

Manufacturing Index: The ISM Manufacturing Index declined in May to 53.5, 6.9 points lower than April. The index has now declined for three straight months. All ten sub-indexes recorded declines in May, underscoring the moderation in the pace of manufacturing activity. The supply chain disruptions caused by the disaster in Japan along with higher energy prices are finally showing up in the numbers.

Despite the sharp deceleration, the overall index remains above the 50-mark that indicates manufacturing expansion, and even above its long-term average of 52.8. While manufacturing experienced a sharp rebound in the early stages of the recovery, it is not unusual for the sector to consolidate some of the gains and slow down later. The basic message is that the factory sector continued to expand although the pace of expansion has moderated.

Inflation: The headline Consumer Price Index (CPI) increased by 0.4% in April. As a result, annual inflation rose to a 3.1% rate. Core CPI – which excludes the more volatile energy and food prices – went up by 0.2%, driving annual core inflation up to 1.3% from 1.2% in March. A significant increase in energy, and to a lesser extent, food prices is driving the headline consumer price index upwards at a steady pace. On the other hand, the more moderate increase in core inflation continues to suggest demand weakness in many sectors, which limits the pass through of higher energy costs in those sectors.

However, a number of areas, such as energy related sectors, the automobile industry, medical care equipment, transportation services and medical care services have been able to pass part or all the increases in costs onto the consumer. As a result, they are prime for improving their profitability or at least minimizing their losses due to higher input costs.



Housing: The housing market remains depressed with a backlog of foreclosures and the continued fall in home prices. The overall level of new home sales remains far below historical levels. The inventory of new homes continues to fall to record lows as builders find little incentive to construct new homes. The excess existing home inventory and the resulting lower prices are making it difficult for new home builders to compete.

Sales of existing homes fell 0.8% in April to a 5.05 million annual unit rate. Poor weather and tighter underwriting standards, tougher appraisals and a slowdown in distressed sales are likely behind the drop in April's sales figures. Distressed sales accounted for 37% of sales. Low borrowing costs and favorable prices have made houses more affordable and have helped revive sales from last year's post tax-credit slump. But many potential buyers are still sitting on the sidelines.

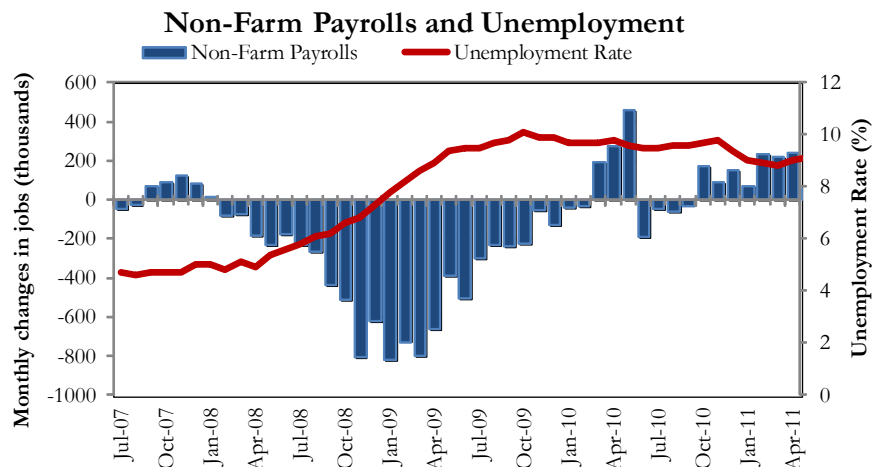
New home sales rose 7.3% in April. This follows an increase in the previous month. The West and Northeast region saw the largest monthly gains in sales although there were improvements across all regions. Despite the sales increase, the overall level remains extremely depressed. The overall inventory of new homes fell to 174,000 units, the lowest level in recent years. Builders remain reluctant to increase inventories as they continue to face tough competition from foreclosures. Housing starts fell 10.6% to a 523,000-unit pace in April from an upwardly revised 585,000-unit pace in the previous month. It remains well below the long-term trend of 1.5 million units.

U.S. home prices declined slightly for the ninth consecutive month in April according to the S&P Case-Shiller Index. This translates into a 3.5% annual decline. A sharp increase in existing homes available for sale during April signals more weakness in housing prices in the near term. The downward pressure exerted on prices by this significant backlog of excess supply is exacerbated by the fact that foreclosures and short-sales, which carry a much larger discount than a non-distressed sale, account for more than a third of total sales in April.

The most recent round of housing data is clearly disappointing. Home sales remain exceptionally weak, single-family home construction is depressed and home prices are continuing to slide amid a glut of foreclosures. To make matters worse, all of this is occurring at a time when interest rates are exceptionally low and monetary and fiscal policies have been unusually supportive. All of these point to a weak housing sector and economy in the coming months.

Labor: Job growth took a disappointing turn in May. Non-farm payrolls rose by just 54,000 compared to the 200,000 plus pace seen during the previous three months. Government payrolls dropped by 29,000, mainly due to cuts in state and local jobs. The unemployment rate also rose to 9.1% from 9.0% in April. This modest increase is not unexpected as previously discouraged workers continue to return to the job market, swelling the labor pool.

Recent initial jobless claims also remain



stuck above the 400,000 mark, suggesting a fairly lackluster job growth in the next two months. Sluggish job numbers also highlight the fragile nature of the US economic recovery and its limited capacity to absorb shocks.

However, as long as energy prices return to a reasonable level and manufacturing disruptions created by Japan's earthquake fade, we remain cautiously optimistic that job growth will move back above the 200,000 level during the second half of 2011.

Monetary Policy: Faster job creation should alleviate some of the strains facing the housing market, which remains the key drag on U.S. economic activity. These facts are weighing more on the minds of the FOMC members than the recent pick-up in inflation, which is why they have decided, for the time being, to carry through with their extraordinary monetary stimulus. Many analysts have blamed the Fed for providing the liquidity necessary to fuel the bull run in commodity prices that has contributed to rising worldwide inflation. Regardless of whether one shares this view, it is indisputable that last month's correction in commodity prices brought them more in line with both the supply and demand fundamentals and the global economic growth outlook. Central banks across emerging markets will have to continue tightening monetary policy to avert inflation spiraling out of control, thus stifling economic growth. In advanced economies, only the Fed, the Bank of Japan, and the Bank of England still maintain their monetary policy stance in crisis-fighting mode, although the latter will likely start raising rates later this year. If commodity prices resume their upward move, that would prompt more forceful policy reactions by central bankers across the globe, further hampering global economic growth.

Economic Outlook: Despite the slowdown in economic growth, Q1 was the best yet in terms of job creation with close to 500,000 new positions. A number of indicators support a return to a more solid pace of expansion in the months ahead – in particular, credit quality continues to improve and credit growth to consumers and businesses has accelerated, suggesting that the slowdown in activity in Q1 is a temporary blip. While government spending is likely to continue to be a drag over the next year, economic momentum is in the hands of the private sector, which will continue to drive the recovery forward.

One potential downside risk for the economy and the markets is the closing of the Federal Reserve's QE2 program. The launch of the QE2 program last August led to a sharp uptrend in risk asset prices, so there has been concern that the end of the program in June will reverse this trend. We do not expect this to happen as the end of QE2 has already been priced into the financial markets. QE2 has been a tailwind for stocks, but only one of many, and the end of the program should not have a significant impact on the markets. It is possible that we will see a modest rise in bond yields when the program ends, but yields have moved lower in recent weeks anyway in the face of some weaker economic data.

The increased cost of energy is another major headwind facing the economy. Oil prices have already risen more than 25% since December. Even if prices remain at current levels, higher energy prices will subtract about 0.5% from growth in 2011 – definitely not enough to push the economy back into recession – but certainly denting the pace of economic recovery.

An additional issue that has some investors concerned is the ongoing debate over potentially raising the debt

ceiling and what it will mean for spending levels. At this point, a consensus seems to be emerging that Congress will cut spending by approximately \$1 trillion over the next 10 years as part of a package to raise the debt ceiling. There is also a growing consensus that spending cuts in the neighborhood of over \$4 trillion are needed to stabilize the country's debt-to-GDP ratio, but changes of that magnitude are unlikely to occur before next year's election.

Despite the recent tone in the markets, not all of the news has been bad. Increased corporate earnings have remained an important source of strength, particularly in the healthcare, technology and materials sectors. In addition, industrial production levels have started to increase as inventories fell; this should help economic growth. Several other factors remain important tailwinds, including still-easy monetary and fiscal policies, high levels of liquidity, strong profit growth and fair valuations. We are also expecting to see some clarity around support mechanisms for the ongoing European debt issues. On balance, we expect these positive forces to prevail, but that may take some time, meaning that continued investment patience is required.

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Index Performance as of May 31, 2011	1 Month	QTD	YTD	1 Year	5 Year
Russell					
3000 Growth Index	-1.16	2.17	8.60	30.02	5.60
3000 Index	-1.14	1.80	8.30	27.04	3.76
3000 Value Index	-1.12	1.43	7.99	24.11	1.80
1000 Growth Index	-1.09	2.22	8.39	29.43	5.55
1000 Index	-1.07	1.90	8.26	26.81	3.69
1000 Value Index	-1.06	1.58	8.14	24.23	1.70
Mid-Cap Growth Index	-0.35	3.26	11.37	36.31	6.54
Mid-Cap Index	-0.42	2.56	10.39	32.59	5.77
Mid-Cap Value Index	-0.48	1.94	9.51	29.36	4.68
2000 Growth Index	-1.95	1.58	10.97	36.79	6.26
2000 Index	-1.87	0.72	8.71	29.75	4.70
2000 Value Index	-1.79	-0.20	6.39	22.91	3.00
S&P 500					
	-1.13	1.80	7.82	25.95	3.32
Consumer Discretionary	-0.30	3.64	8.53	27.14	5.47
Consumer Staples	2.50	7.89	10.61	26.77	9.23
Energy	-4.23	-2.80	13.52	46.83	8.73
Financials	-3.23	-3.22	-0.27	9.28	-11.35
Health Care	2.42	9.09	15.23	27.83	5.59
Industrials	-2.71	-0.03	8.72	29.31	3.40
Information Technology	-1.63	1.27	4.79	21.13	6.94
Materials	-2.75	-0.65	3.86	35.63	6.88
Telecommunication Services	1.64	3.42	8.44	40.45	6.61
Utilities	2.14	6.25	9.17	23.20	5.31
Other U.S. Equity					
Dow Jones Industrial Avg	-1.53	2.54	9.79	27.30	5.19
MSCI USA	-1.08	1.94	8.02	26.63	3.54
Wilshire 5000 (Full Cap)	-1.23	1.63	7.73	26.97	4.08
International Equity - Broad Market					
MSCI EAFE	-2.81	3.10	6.66	31.26	2.22
MSCI Emerging Markets	-2.58	0.46	2.57	29.18	12.04
MSCI Frontier Markets	-3.81	0.89	-4.57	17.02	NA
MSCI AC World	-2.06	2.01	6.63	28.77	4.02
MSCI AC World ex USA	-2.77	2.05	5.61	30.48	4.41
MSCI AC Asia ex Japan	-1.32	2.42	3.66	31.17	12.25
International Equity - Country Region					
MSCI Brazil	-3.11	-3.74	-1.19	19.07	20.04
MSCI BRIC	-2.47	-2.20	0.99	19.94	13.25
MSCI China	0.36	1.99	4.94	18.49	17.15
MSCI Europe	-3.08	4.82	11.70	38.46	3.10
MSCI India	-4.23	-5.23	-10.07	10.67	13.62
MSCI Japan	-1.63	-1.27	-6.06	9.31	-4.13
MSCI EM Latin America	-2.66	-2.16	-1.24	22.50	17.80
MSCI Russia	-6.21	-5.79	9.56	38.68	1.12
Fixed Income					
BC Aggregate Bond	1.31	2.59	3.02	5.84	6.63
Merrill Lynch 3-month T-Bill	0.01	0.03	0.08	0.16	2.08
BC Government	1.42	2.53	2.44	4.31	6.21
BC Credit Bond	1.53	3.25	4.17	9.08	7.22
BC High Yield Corporate Bond	0.49	2.05	6.00	18.22	9.43
BC Muni Bond	1.71	3.53	4.06	3.18	4.78
BC TIPS	0.31	2.83	4.97	8.40	6.80
BofA ML Global Broad Market Ex USD	-0.92	3.34	5.17	16.66	7.14
BofA ML Global Broad Market	0.05	3.01	4.24	11.74	6.91
BofA ML Emerging Market Credit	0.18	2.20	6.21	19.52	10.46
Alternative Investments					
NAREIT Equity REIT Index	1.00	6.16	14.12	31.38	4.30
DJ-UBS US Commodity Index	-5.06	-1.77	2.60	33.02	0.68