



# Economic Commentary and Capital Market Update

May 2011

CAPITAL MARKET CONSULTANTS | 222 EAST ERIE STREET, MILWAUKEE, WI 53202 | WWW.CMARKC.COM | 414-727-7990

**Overview:** Investor risk appetite was tested in the last few weeks by the March 11 East Japan earthquake and tsunami. At the same time, early signs of potential slowing U.S. economic growth have surfaced. The negative economic effect of the Japanese disaster will likely prove temporary, and the rebuilding efforts may provide a boost to future Japanese and global output. But continuing high oil prices are a risk to both near- and long-term global economic growth. While we think the primary driver of oil prices is global economic growth, the current turmoil in the Middle East and North Africa has added a risk premium that is elevating oil prices. We don't see a clear path to eliminating this premium over the near term, as political progress in the region is slow.

The European Central Bank (ECB) has recently joined many emerging-market central banks in raising interest rates in response to rising inflation concerns. We don't see the Fed raising rates until the first quarter of 2012 at the earliest. Although QE2 is technically ending, the Fed will start reinvesting portfolio proceeds to keep its balance sheet from contracting and tightening monetary conditions. In the face of potential fiscal drag from spending cuts, and a growth headwind from high oil prices, this will mitigate another drag to growth. Our current view is that a slowing in economic growth in the U.S. will not lead to another recession, and in that environment we can experience positive returns from both stock and bond markets.

**GDP:** The initial estimate of Q1 2011 GDP growth came in at 1.8%. Growth was supported by real personal consumption expenditures, equipment and software investment as well as the building of business inventories. Subtracting from domestic demand were non-residential building structures and residential investment. However, government consumption was the biggest source of drag with the pullback mainly in defense spending. Net exports have had a roughly neutral effect on growth. The slowdown in economic growth in Q1, following the 3.1% growth Q4, reflects a number of transitory elements including poor weather and a sharp decline in defense spending. All in all, we caution reading too much into the Q1 figures because economic growth appears to have gained traction towards the latter part of the quarter. This sets the stage for a better Q2, which we expect will come in at around 3.0% GDP growth.

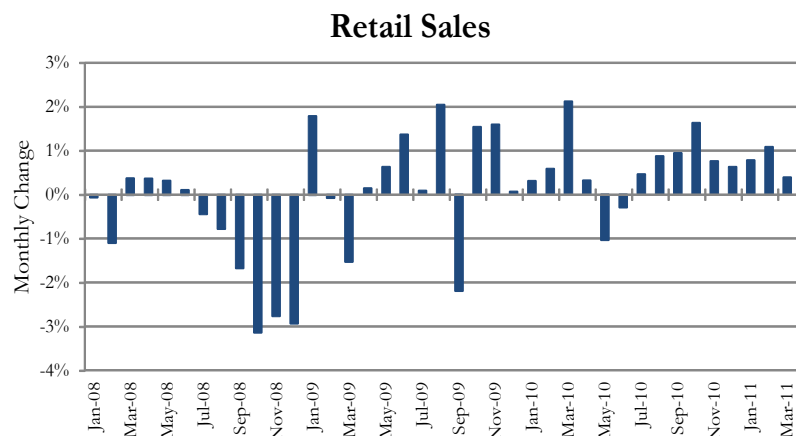
**Consumer Confidence:** U.S. consumer confidence picked up slightly in April. However, current level of consumer confidence remains quite low by historical standards. Consumer confidence is a good predictor of consumers' future behavior. Confidence can be impaired by a few negative headlines dominating the media like the Japanese tragedy, escalating unrest in Africa and the Middle East, and higher oil prices. At this point, we do not believe these events will fundamentally change the trajectory of the U.S. recovery, but they will likely keep April's confidence reading at a low level. Moving forward, as credit conditions improve and jobless claims continue trending downward, we expect consumer confidence to gradually improve. *The equity and bond markets, despite the headlines, appear to be discounting the improved economic conditions this trajectory will bring.*

**Personal Income:** Personal income rose 0.5% in March while personal consumption rose by 0.6%. The personal saving rate remained steady at 5.5%. Services spending, which accounts for 65% of the total spending, increased at its fastest pace since mid-2010 and is now up 2.0% on a year-over-year basis. A more engaged service sector is a strong signal that the economic recovery is becoming more firmly entrenched.

**Retail Sales:** Retail sales rose 0.4% in March, climbing for the ninth straight month. *Retail sales are now up 7.1% on an annual basis, revealing just how much U.S. consumer spending has rebounded.* Not all the news was positive however. Sales of motor vehicles and parts declined which was offset by big gains in gasoline sales. Besides

these two items, sales in other categories were broadly positive. These gains suggest that while higher gasoline prices are clearly having an influence on how consumers are allocating their spending dollars, they are still spending in other categories.

Spending growth thus far has been dependent on purchases of durable goods while spending on non-durables and services has shown almost no growth in Q1 2011. As long as job growth continues to gain traction, spending on the largest components of consumer activity – services and non-durable goods should increase in the coming months providing support for further consumer spending. *The consumer is finally coming back which helps explain the broad-based gains in the domestic equity market.* We expect consumer spending in Q1 2011 to rise by about 3%. This puts the U.S. consumer at the center stage of the economic recovery.



**Industrial Production:** Industrial production dropped 0.1% in February due to a 4.5% decline in utility capacity. Capacity utilization slipped to 76.3 from 76.4 in the previous month. This is low by historical standards. While high commodity prices may present an inflationary pressure, there continues to be plenty of slack and excess capacity which will offset inflation pressures in the coming months. Growth in industrial production so far has been capacity absorbing rather than capacity generating. It is still 5% below its pre-recession peak and capacity utilization remains below its long-run average leading to muted inflationary pressure.

**Housing:** Both housing starts and new home sales rose in March but the levels remain at historic lows. After a setback last month, existing home sales have resumed an upward trajectory. Sales increased in every region except the West. With foreclosures and short sales accounting for 40% of all transactions, median and average sale prices still remain below the pre-recession level.

The oversupply of existing homes on the market and the increasing amount of distressed transactions is hurting recovery in the housing sector. With builders still reluctant to increase inventories, the overall inventory of new homes fell to its lowest level in four decades allowing the shadow inventory of existing homes to clear faster.

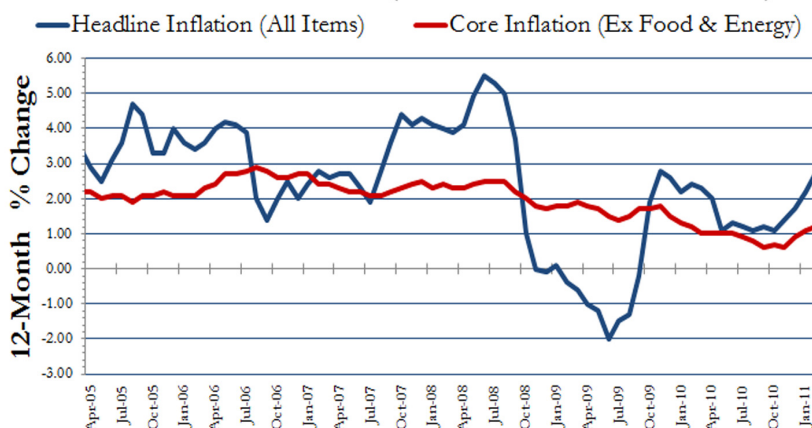
The housing market has lagged significantly behind the broader economic recovery. Past attempts at boosting housing demand through temporary tax stimulus have only added to the volatility in home sales and have done little to change the underlying fundamentals and trend. However, with job growth beginning to gain some traction, we expect existing home sales to continue to increase in the coming months though we are still a long way from a healthy housing market.

**Inflation:** Headline consumer prices (CPI) rose by 0.5% in March to take the year-over-year index to 2.7%. The

biggest contributors to March's inflation reading were, not surprisingly, energy and food prices. The core CPI increased by only 0.1% taking the yearly index to 1.2%. The increase in core prices was generalized across sectors.

While it is the overall price index that affects the purchasing power of consumers, the Federal Reserve is focused on core inflation because it captures broad-based price pressures rather than the volatile swings in commodity prices. There are no indications that the rest of the economy's prices, outside food and energy, are being affected by this increase in commodity prices.

### Inflation (Consumer Price Index)



*We believe the increase in prices is temporary and is not going to pass through to the rest of the economy. This allows the Fed to keep its expansionary monetary stance regarding monetary policy for a longer period. This should continue to underpin economic growth and support further risk taking in the capital markets.*

**Labor Market:** U.S. non-farm payrolls rose by 216,000 in March while the unemployment rate dropped to 8.8%. Government payrolls continued to decline, marking the fifth straight month that government payrolls have subtracted from the total. The decline was entirely at the local government level, a trend that is likely to continue in the coming months as they try to manage their budget shortfalls. Private job creation in Q1 of 2011 accelerated at the fastest pace since the U.S. recovery began. This is *further evidence that expansion has entered a new phase of self-sustained private demand growth.*

The four-week moving average of initial jobless claims figures, one of the most important forward-looking indicators for the labor market, inched higher in the last few weeks and is now at 406,500. This may be signaling slower job growth in the coming months. Moreover, as discouraged workers rejoin the labor force, we expect the unemployment rate to decline more slowly and remain at or above 8.5% by the end of 2011.

**Federal Reserve:** The Fed has signaled that they will end their QE2 strategy of buying \$600 billion in U.S. Treasury bonds. This comes as no surprise. QE2 achieved some of its objectives; in particular it dramatically reduced the threat of deflation and facilitated a rebound in riskier assets. In addition, it nudged down the value of the dollar, giving U.S. exports a lift. While analysts and investors debate whether the end to the bond buying effort will have a significant impact on financial markets, we believe that it will pass without any major disruptions. We agree with the Fed's assertion that the economic recovery is proceeding at a moderate pace and the labor market is showing signs of improvement.

*The Fed will be reinvesting maturing debt into Treasuries as a way to continue further stimulus. Once repurchases slowed or stopped, it will be a clear signal that the Fed is moving towards a tighter policy stance. We, however,*

think the idea of a QE3 is off the table since the risks of deflation appear negligible. Core inflation has increased but is still below the Fed's goal of about 2%. We see no urgency for any adjustment to current monetary policy. Interest rates should remain on hold for the remainder of 2011. This policy stability should provide the markets with a sense of assurance.

**Outlook:** Despite the slowdown in economic growth, *Q1 was the best yet in terms of job creation with close to 500,000 new positions*. Moreover, 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.

The elevated cost of energy is one of the major headwinds 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. Looking forward, we expect GDP growth to improve to around 3.0% in the second quarter and to 3.5% in the second half of the year – conditional on stabilization in oil prices.

S&P's recent outlook downgrade of U.S. credit rating to 'negative' did not reflect weakness in the economy. Instead, the announcement served as a reprimand against politicians' inability to compromise. The timing of the announcement was well-placed, too, coming as it did at a moment when deficit reduction is increasingly dominating the political debate in Washington. While Congress will almost certainly vote to raise the debt ceiling in May, House Republicans have used it as a means of extracting budgetary concessions from the Democrats. Last month, House Republicans and the Obama administration released their respective plans to fix the nation's long-term budgetary woes. Unfortunately, neither party has come up with a solution amenable to policymakers across the aisle. The Democrats are reluctant to cut spending where it matters – the nation's entitlement programs that need the most fixing – while the Republicans are loathe to raise taxes. Any long-term solution requires a serious look at both options.

It is important to remember that these spending issues are long-term problems: the U.S. is still investors' favored and most trusted sovereign despite all the headlines. The U.S. Treasury market is the most liquid in the world and U.S. bonds are still very much the safe haven of last resort and will continue to hold such a privileged financial position for the foreseeable future.

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Index Performance as of April 30, 2011	1 Month	QTD	YTD	1 Year	5 Year
<b>Russell</b>					
3000 Growth Index	3.37	3.37	9.88	21.62	5.05
3000 Index	2.98	2.98	9.55	18.35	3.33
3000 Value Index	2.58	2.58	9.21	15.17	1.47
1000 Growth Index	3.35	3.35	9.58	20.87	5.06
1000 Index	3.01	3.01	9.44	18.02	3.30
1000 Value Index	2.66	2.66	9.29	15.24	1.40
Mid-Cap Growth Index	3.62	3.62	11.75	27.40	5.59
Mid-Cap Index	2.99	2.99	10.85	23.36	5.14
Mid-Cap Value Index	2.43	2.43	10.04	19.84	4.34
2000 Growth Index	3.60	3.60	13.17	30.29	5.14
2000 Index	2.64	2.64	10.79	22.20	3.89
2000 Value Index	1.62	1.62	8.33	14.57	2.50
<b>S&amp;P 500</b>					
Consumer Discretionary	3.96	3.96	8.86	18.60	5.21
Consumer Staples	5.25	5.25	7.90	17.99	8.82
Energy	1.49	1.49	18.53	35.86	9.04
Financials	0.01	0.01	3.05	2.57	-11.43
Health Care	6.52	6.52	12.50	16.42	4.67
Industrials	2.75	2.75	11.75	20.25	3.64
Information Technology	2.94	2.94	6.52	13.16	5.74
Materials	2.16	2.16	6.80	26.26	6.60
Telecommunication Services	1.75	1.75	6.69	32.80	5.62
Utilities	4.02	4.02	6.88	13.85	5.20
<b>Other U.S. Equity</b>					
Dow Jones Industrial Avg	4.13	4.13	11.49	19.50	5.20
MSCI USA	3.06	3.06	9.20	17.69	3.15
Wilshire 5000 (Full Cap)	2.90	2.90	9.07	18.39	3.67
<b>International Equity - Broad Market</b>					
MSCI EAFE	6.08	6.08	9.74	19.70	2.02
MSCI Emerging Markets	3.12	3.12	5.29	21.00	10.17
MSCI Frontier Markets	4.89	4.89	-0.79	10.53	NA
MSCI AC World	4.15	4.15	8.87	19.13	3.63
MSCI AC World ex USA	4.96	4.96	8.62	20.22	4.01
MSCI AC Asia ex Japan	3.79	3.79	5.05	21.81	10.82
<b>International Equity - Country Region</b>					
MSCI Brazil	-0.65	-0.65	1.98	10.01	16.60
MSCI BRIC	0.28	0.28	3.55	12.78	11.01
MSCI China	1.62	1.62	4.56	11.74	15.83
MSCI Europe	8.15	8.15	15.25	25.77	3.20
MSCI India	-1.04	-1.04	-6.10	6.32	11.15
MSCI Japan	0.37	0.37	-4.51	2.13	-5.05
MSCI EM Latin America	0.51	0.51	1.46	15.03	14.95
MSCI Russia	0.45	0.45	16.82	31.55	0.24
<b>Fixed Income</b>					
BC Aggregate Bond	1.27	1.27	1.70	5.36	6.33
Merrill Lynch 3-month T-Bill	0.02	0.02	0.07	0.17	2.16
BC Government	1.09	1.09	1.00	4.42	5.92
BC Credit Bond	1.69	1.69	2.60	7.03	6.85
BC High Yield Corporate Bond	1.55	1.55	5.49	13.42	9.32
BC Muni Bond	1.79	1.79	2.31	2.20	4.52
BC TIPS	2.51	2.51	4.64	8.06	6.79
BofA ML Global Broad Market Ex USD	4.29	4.29	6.15	14.02	7.84
BofA ML Global Broad Market	2.96	2.96	4.19	10.15	7.19
BofA ML Emerging Market Credit	2.02	2.02	6.02	14.14	10.19
<b>Alternative Investments</b>					
HFRI Equity Hedge	1.21	1.21	3.15	11.71	4.32
HFRI Equity Market Neutral	0.55	0.55	2.64	7.04	2.72
NAREIT Equity REIT Index	5.11	5.11	12.99	22.86	3.50
DJ-UBS US Commodity Index	3.46	3.46	8.06	30.40	1.92