



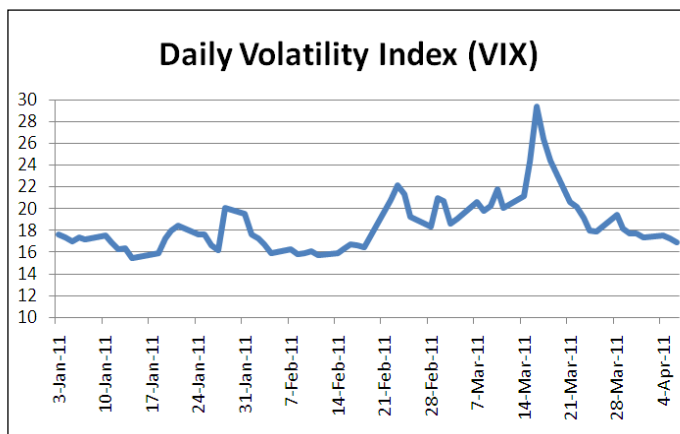
# Economic Commentary and Capital Market Update

First Quarter 2011

Dr. Abdur Chowdhury  
Chief Economist of Capital Market Consultants, LLC  
Mintz Levin Financial Advisors, LLC Consulting Economist

## Overview: Economic Expansion Expected to Continue.

The first quarter of 2011 brought us significant new concerns about the global economy. So far, the year has delivered a new war in Libya, continuing and expanding unrest in the Middle East, and a tragic earthquake in Japan. These events have all worked together to keep investors on edge, causing significantly higher levels of market volatility (see S&P 500 Daily Volatility Chart below). Predicting the exact outcome of all these events is, of course, impossible. However, our expectation is that none of these risks will derail the global economic recovery.



We believe that the U.S. employment outlook is improving. This is in part due to slowing corporate productivity, which suggests that firms require additional new hiring to increase output, rather than making better use of existing employees. This is an important turn in the business cycle, since strong productivity growth was responsible for much of the gains in output earlier on in the recovery. Also, a slowdown in productivity at this point in the cycle implies

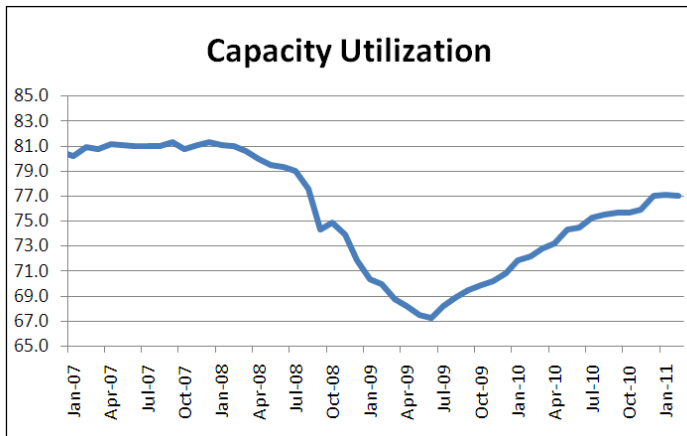
that firms have trimmed nearly all of their waste and are now taking advantage of their improved efficiency by hiring. The conditions remain well suited for the recent acceleration in private sector job growth to continue in the months ahead. This gives us hope that growth during Q2 and Q3 will accelerate in a big way.

**GDP:** The Q4 2010 final GDP was reported at an annual rate of 3.1%. Net exports made the largest contribution to growth at the end of the year. Additionally, consumer spending aided by rising demand for durable goods, rose by 4.0%, the highest level of increase since before the recession began.

**Manufacturing:** According to the Institute for Supply Management, the U.S. manufacturing index in March remained stable at nearly its highest reading since May 2004. This strength is generating job growth, a necessary ingredient to a sustained economic expansion. The fact is, manufacturing has been the star of this economic recovery. While making up only around 12% of total economic output in the U.S., manufacturing has contributed over 30% of the economy's growth since the recession ended. This large contribution is primarily due to inventory investment, rising demand for durable goods, and an underperformance from housing and services. With low interest rates and pent up demand for manufactured goods at home, and a continued global recovery supporting U.S. exports, manufacturing is likely to remain a key source of economic growth and job creation in 2011.

**Industrial Production: Slack Sufficient to Offset Inflationary Pressures.** Industrial production was steady in February while capacity utilization remained at just over 76% (see Capacity Utilization Chart below). The latter remains low

by historical standards. So, while high commodity prices may present a current inflationary pressure, there continues to be plenty of slack and excess capacity in the system, which will offset inflationary 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 below its long-run average.



**Retail Sales: The Consumer Is Coming Back.** Retail sales increased 1.0% (seasonally adjusted) in February. Gains in February were broad-based, but the biggest monthly increase was in the sales of automobiles and parts which jumped 2.3%. Note that February is a famously slow month for retailers. Retail sales in February showed a modest increase in store sales, so the seasonally adjusted number perhaps overstates the strength of sales somewhat. Still, the fact that sales did not drop off the way they usually do in February is encouraging. We expect consumer spending in Q1 2011 to rise by about 3%. This puts the U.S. consumer back at the center stage of the economic recovery.

**Housing:** The housing market continues to be the economy's Achilles' heel. Housing starts declined by 22.5% in February, the lowest level since April 2009. The volatile multi-family home construction dropped by 46% while single-family home construction fell by about 12%. Building permits, an indicator of future construction, decreased by about 8%, the lowest level on record. Sales of new single-family homes in February 2011 were at a seasonally adjusted annual rate of 250,000, a 16.9% drop from January. Relative to a year ago, sales are down 28%!

In addition to the drop in existing home sales, the price of new homes also declined. The median price of a new home sold fell 13.9% in February to \$202,000 which is 8.9% below the previous year. The differential between the median price

of a new and existing home has increased from the historical level of around 12% to the current level of more than 25%. The increase in foreclosure and short sales is undoubtedly a significant factor in pulling existing home prices lower. The existence of this unusually large price gap, along with rising materials prices, is making it difficult for builders to compete with the existing supply of homes.

Declining prices are slowing demand, weighing on household wealth and also leaving consumers with larger mortgages than their houses are worth. The foreclosure pipeline is almost as large as the 3.5 million inventory of unsold existing homes. Unless the inventory of foreclosure drops, the median price differential will remain at the elevated level while construction activity will remain at very low levels.

However, all is not negative in the housing market. We expect a number of factors to provide a boost in the housing market in the coming months including easing credit conditions, affordable prices, improvements in mortgage delinquencies and the foreclosure market. Increased hiring and improved consumer confidence would also be helpful.

**Inflation: Still under Control.** Consumer prices increased by 0.5% in February, bringing the rate of headline inflation to 2.2% on a year-over-year basis. The core CPI, which excludes energy and food prices, also increased by 0.2% in February and year-over-year core CPI increased to 1.1%. In the core measure the increase in prices was basically broad-based. We expect the difference between the headline and core inflation to continue over the remainder of the year as food and energy prices continue to increase. High unemployment and slow personal income growth should keep a lid on core inflation growth in the coming months. Navigating this gap creates a new challenge for the Federal Reserve Bank, who must be careful that higher commodity prices don't feed into inflation expectations and ultimately higher core inflation.

Separately, the core producer price index (PPI) for February increased by 0.2% following a 0.5% rise in January. The PPI for finished goods increased by 1.6% due to strong increases in food and energy prices. As the U.S. economy continues to gain momentum, higher PPI will start to make inroads into consumer prices (CPI). However, given that the economy still has some slack and employment is not growing as fast as in other recovery cycles, the effect on core CPI due to any increase in PPI should be minimal. However, the increase in PPI could have an impact on corporate profitability for manufacturing and industrial companies that have to

deal with rising energy and commodity input costs. The equity markets are likely to reflect this change in the coming months.

**Labor market: Slow but Steady Improvement.** 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 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.

With this pace of hiring, the U.S. economy can now begin to make more serious headway in replacing the 8.7 million jobs lost during the recession. We expect to see more than 2 million jobs created in 2011 alone. Nonetheless, as discouraged workers rejoin the labor force—the unemployment rate will decline more slowly than this growth would suggest. We expect the unemployment rate to be at around 8.5% by the end of 2011.

**Federal Reserve: The Policy Stakes Are Rising.** A high unemployment rate along with increasing price pressures does not make the Federal Reserve's management of this expansion any easier. With employment momentum picking up in the last two months, the task for the Fed will turn increasingly to managing an exit strategy from the second round of quantitative easing (QE2). QE2 did have some success, helping to drive the stock market higher and leading to a general increase in risk taking, as evidenced by the recent pick up in merger and acquisition activity and issuance of junk bonds. Despite growing worries about inflation, we expect the Fed to complete QE2 as planned in June. Interest rates will be on hold until at least the end of 2011.

**Trade:** The U.S. trade deficit widened to \$46.3 billion in January due primarily to rising oil prices.

The recent rise in oil prices and stronger consumer spending and business investments will likely lead to higher imports, putting upward pressure on the U.S. trade deficit throughout 2011. A relatively weaker U.S. dollar—the trade-weighted currency has depreciated roughly 6.8% since mid-2010—could provide some offset by boosting exports. However,

if concerns regarding the European sovereign debt situation escalate and political turmoil in the Middle East continue, the dollar will likely appreciate, eroding this recent competitiveness gain.

**Economic Outlook:** We expect both the global and U.S. economic recovery to remain on track, and do not expect to see inflation rise noticeably in the developed world. Corporate profits have remained strong and preliminary indications are that corporations are not being too adversely affected by the increase in energy costs. In fact, corporate hiring plans have been accelerating and we expect job creation to continue.

Although we continue to have a generally optimistic view of the economic backdrop to the capital markets, a number of downside risks persist. One issue is the threat of a federal government shutdown. Although signs are pointing to a growing likelihood of some sort of budget agreement, the potential uncertainty remains. Additionally, investors need to be aware that even if the budget for the current fiscal year can finally be agreed upon, negotiations are already beginning for the 2012 fiscal year, which begins on October 1, 2011, meaning that the question of a budget impasse is not likely to fade in the near term.

Also, some investors are concerned about what will happen when the current Federal Reserve asset purchase program (QE2) is completed on June 30, believing that the end of the Treasury purchases will result in a negative shock for interest rates and stocks. We believe that such concerns are likely overdone. Previous experiences show that when the Fed eased up on its purchase of mortgage securities, the markets managed the transition without a serious problem. Given the cash on hand, improving sentiment, and strengthening economy, we see no reason for panic.

The short-term risks are clearly dominating market sentiment and confidence levels have dropped. Moving the market past all of this will require some time as well as additional clarity on the downside risks.

#### Other Matters

In accordance with SEC regulations, we request that you contact us in the event that there have been any material changes in your financial circumstances or investment objectives, or if you wish to impose any reasonable restrictions on the management of your accounts or modify existing restrictions on the management of your accounts.

## Index Performance as of March 31, 2011

	1 Month	QTD	YTD	1 Year	5 Year
<b>Russell</b>					
3000 Growth Index	0.42	6.30	6.30	19.24	4.32
3000 Index	0.45	6.38	6.38	17.41	2.95
3000 Value Index	0.48	6.47	6.47	15.60	1.43
1000 Growth Index	0.12	6.03	6.03	18.26	4.34
1000 Index	0.26	6.24	6.24	16.69	2.93
1000 Value Index	0.40	6.46	6.46	15.15	1.38
Mid-Cap Growth Index	1.63	7.85	7.85	26.60	4.93
Mid-Cap Index	1.53	7.63	7.63	24.27	4.67
Mid-Cap Value Index	1.44	7.42	7.42	22.26	4.04
2000 Growth Index	3.75	9.24	9.24	31.04	4.34
2000 Index	2.59	7.94	7.94	25.79	3.35
2000 Value Index	1.39	6.60	6.60	20.63	2.23
<b>S&amp;P 500</b>					
Consumer Discretionary	-0.51	4.71	4.71	21.04	4.67
Consumer Staples	1.62	2.52	2.52	10.56	7.88
Energy	1.54	16.80	16.80	39.82	9.81
Financials	-2.58	3.04	3.04	3.95	-10.68
Health Care	1.89	5.62	5.62	5.11	2.70
Industrials	1.78	8.75	8.75	21.88	3.49
Information Technology	-2.61	3.47	3.47	11.88	4.88
Materials	1.87	4.54	4.54	24.18	6.89
Telecommunication Services	5.28	4.85	4.85	30.37	4.79
Utilities	0.25	2.74	2.74	12.32	4.70
<b>Other U.S. Equity</b>					
Dow Jones Industrial Avg	0.91	7.07	7.07	16.51	4.87
MSCI USA	0.12	5.96	5.96	16.03	2.80
Wilshire 5000 (Full Cap)	0.34	6.00	6.00	17.57	3.30
<b>International Equity - Broad Market</b>					
MSCI EAFE	-2.20	3.45	3.45	10.90	1.78
MSCI Emerging Markets	5.90	2.10	2.10	18.78	11.01
MSCI Frontier Markets	1.32	-5.41	-5.41	5.45	NA
MSCI AC World	-0.06	4.53	4.53	14.63	3.48
MSCI AC World ex USA	-0.19	3.49	3.49	13.61	4.05
MSCI AC Asia ex Japan	6.29	1.22	1.22	19.80	11.44
<b>International Equity - Country Region</b>					
MSCI Brazil	4.00	2.65	2.65	9.74	18.93
MSCI BRIC	5.70	3.26	3.26	12.23	12.61
MSCI China	5.32	2.88	2.88	9.58	16.65
MSCI Europe	-0.79	6.56	6.56	13.29	2.64
MSCI India	11.11	-5.11	-5.11	9.46	12.16
MSCI Japan	-9.12	-4.85	-4.85	1.60	-4.57
MSCI EM Latin America	3.58	0.94	0.94	14.06	16.61
MSCI Russia	5.17	16.29	16.29	30.06	2.46
<b>Fixed Income</b>					
BC Aggregate Bond	0.06	0.42	0.42	5.12	6.03
Merrill Lynch 3-month T-Bill	0.03	0.05	0.05	0.16	2.23
BC Government	-0.03	-0.08	-0.08	4.28	5.63
BC Credit Bond	-0.04	0.89	0.89	7.01	6.42
BC High Yield Corporate Bond	0.32	3.88	3.88	14.31	9.12
BC Muni Bond	-0.33	0.51	0.51	1.63	4.14
BC TIPS	1.01	2.08	2.08	7.91	6.25
BofA ML Global Broad Market Ex USD	0.69	1.78	1.78	8.54	7.63
BofA ML Global Broad Market	0.42	1.19	1.19	7.05	6.93
BofA ML Emerging Market Credit	2.10	3.92	3.92	15.00	9.82
<b>Alternative Investments</b>					
HFRI Equity Hedge	0.31	1.92	1.92	11.89	4.44
HFRI Equity Market Neutral	0.73	2.07	2.07	7.05	2.87
NAREIT Equity REIT Index	-1.28	7.49	7.49	25.00	1.70
DJ-UBS US Commodity Index	2.06	4.45	4.45	28.49	2.57